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Editorial Comment

Opportunities and Obligations

There is a tide in the affairs of men
Which, taken at the flood, leads on to fortune;
Omitted, all the voyage of their life
Is bound in shallows and in miseries.
On such a full sea are we now afloat;
And we must take the current when it serves,
Or lose our ventures.

So spoke Brutus to Cassius in Shakespeare's *Julius Caesar;* we know of no more appropriate words of wisdom for Canadians today.

The democracies of the world have on their hands the greatest task and the noblest duty of all time—to drive back the hordes of Hitlerism, whose only aims are death and slavery for all opposing their diabolical designs, and to rescue the nations of Europe who have fallen prey to the Nazi oppressor. The people of Great Britain are the first line of defence against these attacks on the English-speaking world and freedom-loving peoples. They are looking to this continent for help. If Canadians neglect their obligations, Great Britain, North America and the rest of the world will be forced to succumb, and we and all other peace-loving nations will be "bound in shallows and in miseries."

Deeds must now take the place of idle words and pious hopes; determination must replace apathy and unconcern. Every Canadian has an obligation not only to buy but also to encourage the purchase weekly and monthly of more and more War Savings Certificates. Then we shall be furnishing to those in the first line of defence what Mr. Churchill has described as "the tools to finish the job."

Canadian Industrial Activity

The urgent demands of war have brought a state of unprecedented industrial activity in this country. According to the latest issue of the *Monthly Review* of The Bank of Nova Scotia, the year 1940 witnessed the largest production of goods and services in Canadian history and at the beginning of 1941 found many industries operating at or near maximum capacity. As some indication of that activity, the index of employment in Canada rose from the 1925-29 average of 116% to 126% on 1st December last and continues its upward trend. It is estimated that since the war commenced the increase in the number of people employed is 350,000, which, of course, does not include about 200,000 men added to the armed forces. The *Review* points out that this brings employment to much the highest level on record.

The extent of the increased production arising from the war is indicated in the monthly publication of the Dominion Bureau of Statistics, which states that Canada up to the end of 1940 had expended $23 million more in purchases since the outbreak of war than was spent for munitions and materials exported from Canada in the whole four years of war from 1914 to 1918. For war purposes alone, the purchases for Canada and Great Britain amounted to $1,025 million. The value of munitions and materials sent out of Canada in the last Great War amounted to $1,003 million.

Demand on Profession

War-time conditions have made pressing demands upon our profession, and during the past eighteen months there has been an increasing call from industry and the Dominion government for chartered accountants to fill responsible posts. Because of this situation, the Executive Committee of the Dominion Association has suggested to the Provincial Institutes the advisability of conducting a mid-year

Final examination in 1941 so that candidates eligible to write this examination may do so. The successful ones would in consequence be ready to meet the call from industry and the government six months in advance of the annual examination held in December. The suggestion will be receiving the earnest consideration of Institute councils.

Income Tax Rulings

The executive committee of The Dominion Association of Chartered Accountants was able a few days ago to send to the members of the Association resident in Canada a copy of a number of rulings of the Income Tax Division of the Department of National Revenue. The rulings are published elsewhere in this issue.

The publication of all such rulings contributes very considerably to the more effective administration of the *Income War Tax Act* in at least two ways — a decision of the Income Tax Division becomes known to all concerned and not to a few, and we as a profession are able to save the time of the officials of the Income Tax Division answering hundreds of telephone calls they otherwise would be receiving had only a few known about the rulings.

The editorial committee, then, welcomes the opportunity of publishing all information that will assist the Income Tax Division in days of national emergency. It hopes, moreover, that the Department of National Revenue in this and in other ways will make more use of our profession and THE CANADIAN CHARTERED ACCOUNTANT because of the service which they can render.

Auditors and Third Parties

Widespread interest of public accountants in the United States is being shown in the case of *State Street Trust Company* v. *Ernst et al.* which was recently before the New York Court of Appeals. The substance of the decision of the court is that certain acts of the accountants in this case were of such a nature as to raise "an inference of fraud" on their part and to make possible a recovery by a third party for a loss alleged to have been sustained as a result of such acts. We are indebted to the American Institute of Accountants for supplying us with a copy of the

observations of one of its members on the case[1] for reference in THE CANADIAN CHARTERED ACCOUNTANT.

Briefly the facts are as follows: On 19th January 1929, Greenstein, the president of Pelz-Greenstein, a firm of commercial factors, sought from this trust company a line of credit and a loan of $300,000. He was unknown to the trust company but carried a letter of introduction from a New York bank. He explained in detail the nature and extent of the business of his firm and in support thereof presented an "estimated balance sheet" (not audited) as at 31st December 1928, showing capital stock and surplus of over $3,000,000. In further explanation, he asserted that the accounts receivable were insured; that his company had loans or lines of credit with various banks, which he named, amounting to $3,900,000 (although the balance sheet showed the amount as $4,275,000 as at 31st December 1928); that the notes of the company were customarily guaranteed by himself and two other stockholders whose combined "means" amounted to about $800,000; and that the company was beneficiary under life insurance policies on the lives of two stockholders aggregating $800,000. He added that the company's accounts for the year 1928 were being audited by the defendant accountants and that within a reasonable time certified statements would be submitted.

The trust company officials gave due consideration to Greenstein's application and, after receiving satisfactory replies to letters of enquiry to the other lending banks, decided that, while no line of credit would be granted or time loan made until receipt of his company's financial statement certified by the auditors, they would be prepared to make a demand loan of $300,000. Pelz-Greenstein were so notified, and this loan was made on 1st February. It can be stated at this point that from the evidence in the case it was conceded that the accounts as set forth in Pelz-Greenstein's financial statement were in many respects false and that the company was hopelessly insolvent when this loan was made. The trust company was thus "taken for a ride" without any assistance from the public accountants or reliance on the statement certified by them.

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[1]James L. Dohr, *Some Reservations on the State Street Trust Company Case.* Mr. Dohr is a member of the American Institute of Accountants, associate professor of accounting at Columbia University and a member of the law firm of Grune & Grune, New York.

On 9th April Greenstein filed with the trust company a balance sheet as of 31st December 1928 and an income statement for the year 1928 certified to by the defendant accountants, and renewed his request for the line of credit and the time loan. The officers of the trust company compared these statements with the documents filed by Greenstein on 19th January and concluded that they were "substantially in agreement" although, as the evidence later proved, they were not justified in this conclusion. On 9th April the demand loan was replaced by a three-months' loan, which was renewed for similar periods on 9th July, 9th October and 9th January 1930. Before another renewal date came round Pelz-Greenstein went into bankruptcy and the trust company suffered a loss of over half its loan, or about $173,000. It should be mentioned that on 3rd October, without any request on their part, the trust company received from Greenstein a condensed balance sheet (not audited) as at 29th June 1929; at the trial the trust company's representatives testified that they had studied the condensed balance sheet and had relied on it in granting the extensions.

Although the financial statements certified by the accountants had been delivered to the trust company on 9th April, it was not until 9th May that the accountants delivered to Pelz-Greenstein their "Report of Examination," consisting of (1) a letter to the company setting forth the scope of the audit and containing comments on the company's financial condition and earnings, (2) a balance sheet as of 31st December 1928, identical, except for some minor matters of arrangement, with the condensed statement, (3) an income and surplus account for the year ending 31st December 1928, identical, except for some elaborations of expense classifications, with the condensed statement, and (4) some schedules of cash on deposit, commission accounts receivable, notes payable and drafts payable. Nothing in these statements in any sense of the word contradicted or altered the condensed statement. This delay in reporting on the financial statements had its repercussions. In the opinion of the majority of the judges of the Court of Appeals it served to sustain an "inference of fraud." The accountants, they stated, had allowed a period of thirty days to elapse before sending the covering letter and had in their possession information which they totally sup-

pressed on the certified balance sheet and which they had disclosed to Pelz-Greenstein alone. Thus they had been guilty of an act which was equivalent to active misrepresentation.

In its court action against the accountants, the trust company was required to prove under the rules laid down in the *Ultramares Corporation* case that the defendants had committed a fraud or that their acts had amounted to one of the four recognized substitutes[2] of fraud as enunciated in that case. That is, it was not sufficient to show that the accountants were negligent or that they had exercised bad judgment. After the plaintiffs had presented their side of the case the defendants moved to dismiss the action and allowed the case to rest without calling any witnesses. The outcome was that a verdict in favour of the defendants was given in the trial court, which was unanimously affirmed by the five judges sitting in the Appellate Division. On further appeal to the Court of Appeals of New York, however, the decision was reversed (four judges concurring and two dissenting) and a new trial was ordered.

In his comments on the case, Mr. Dohr has pointed out that eight of the twelve judges who considered the matter were of the opinion that the trust company should not recover. "Bearing in mind that the plaintiff could not recover for *negligence* on the part of the accountants," he concludes, "it seems amply evident that their conduct in this case was not such as to raise an inference of fraud or any of the substitutes therefor upon which a 'third party' can recover. A fair reading of the testimony indicates that at worst the accountants were negligent; at best the trust company was equally so. In so far as the decision affects the integrity of the accountants, a serious injustice has been done. In addition, there are no facts here on the basis of which it might be said that the trust company in fairness should be allowed to recover from the accountants. It is perfectly clear that the trust company made a loan, before it received any financial statement from the accountants,

[2]These are (a) That the accountants' statement was deliberately and intentionally or recklessly dishonest (fraudulent), or (b) That the accountants made a pretension of knowledge "when knowledge there was none," or (c) That the accountants' opinion was based on grounds so flimsy as to lead to the conclusion that there was no genuine belief back of it, or (d) That their audit was so negligent as to justify a finding that they had no genuine belief in its adequacy.

to a company which was hopelessly insolvent at the time. When such statements were received they differed enough from the estimated balance-sheet to put the trust company on notice and to require further inquiry. Finally, the reliance of the trust company on the condensed statements in the subsequent renewals of the loan can scarcely be justified.

"As to whether or not the accountants were negligent, the record on the whole is not conclusive because the defendants rested (quite properly, since no fraud had been proved) without putting in their case. The negligence question, therefore, cannot be fairly answered without a detailed study of the full facts."

Two Scholarly Canadians

Since our February issue went to press Canada has lost two scholarly sons, both of whom had taken a personal interest in the profession of the chartered accountant —Dr. Oscar D. Skelton, Under-secretary of State for Foreign Affairs, and Professor Robert McQueen, Head of the Department of Economics at the University of Manitoba.

Possibly few know of the contribution made by Dr. Skelton towards the establishment twenty years ago of the study courses of the Ontario Institute, which have been a source of help to students throughout Canada during all these years. As Dean of the Faculty of Arts of Queen's University at that time, and with the able assistance of Dr. W. C. Clark, Professor of Economics at Queen's (now Canada's Deputy Minister of Finance), Dr. Skelton co-operated with the Institute in the preparation of the first lecture courses and in their successful administration. It was during these years that your editor as Director of Extramural Studies at Queen's had close association with Dr. Skelton—the memory of which will always remain an inspiration. In 1925 Dr. Skelton was chosen for the important post which he held until the time of his sudden death on 28th January. Of a cool judicial temperament, possessing great scholarship and intellectual industry, he was peculiarly fitted for this high post at Ottawa. As Councillor of Foreign Relations he had exercised very considerable influence upon the evolution of government policies and the promotion of practical schemes of Imperial co-operation. When the Dominion

government today is in need of men of capacity, vision and high resolve, it can ill afford to lose the services of one with Dr. Skelton's qualifications.

Professor McQueen had become known to our readers through his monthly articles in The Canadian Chartered Accountant, and his untimely death in the aeroplane crash on 6th February was a shock to us all. In the words of President Sydney Smith of Manitoba University "He was a great Canadian, preferring always the national to the sectional viewpoint." That helps to explain why he had been chosen as one of the directors of the Bank of Canada—and it was during his return from a meeting of the directors that his death took place. He, too, had taken a personal interest in the educational programme of our profession and at the time of his death was active in the student training courses of the Manitoba Institute. An observant student of economic and political problems, a teacher of unusual ability and an after-dinner speaker of rare charm, Professor McQueen's passing is a loss that will be keenly felt by a host of friends and acquaintances right across the Dominion.

Just before going to press this month we received from Mrs. McQueen another in the series of articles written by her late husband for The Canadian Chartered Accountant. The preparation of it by Professor McQueen a few days before his death emphasizes the fact that the articles in this series, from the pen of one whose time and talents were occupied in numerous directions, were not written hastily but were the product of an ordered mind and of a heart set on Canada's good. Though dead he still speaks.

POOLING RETURNS FROM THE SALE OF AGRICULTURAL PRODUCTS

By W. F. Chown, Chartered Accountant, Ottawa

DURING the 1939 session, Parliament enacted *The Wheat Co-operative Marketing Act* and *The Agricultural Products Co-operative Marketing Act* for the purpose of encouraging the co-operative marketing of farm products. These acts provide that the Dominion government may, by agreement, authorize co-operative associations to make initial payments to primary producers on the delivery of products for sale on a co-operative plan, and undertake to reimburse them if the amount realized by sale is less than the amount of the initial payments and marketing charges. Payments subsequent to the initial payment must first be approved by the governor-in-council. The books and accounts must be inspected and audited by chartered accountants approved by the governor-in-council.

This legislation has drawn attention to the problem of pooling returns, and accountants and auditors have in some instances been confronted with problems with which they have had no previous experience.

According to *The Agricultural Products Co-operative Marketing Act, 1939* (as amended) "A co-operative plan means an agreement or arrangement for the marketing of agricultural products which provides:

"(i) for equal returns to primary producers for agricultural products of like grade and quality;

"(ii) for the return to primary producers of the proceeds of the sale of all agricultural products delivered thereunder produced during the year, after the deduction of processing, carrying and selling charges;

"(iii) for an initial payment to primary producers . . . ."

When a farmer or rancher delivers produce for sale on such a plan he surrenders title to the product and acquires in exchange a fractional interest in a pool and in settlement will receive exactly the same as other participants for the same grade and quality, less the costs of processing, carrying and selling and a deduction for a reserve, if such is included in the agreement or arrangement. In view of

the government's undertaking to reimburse for losses, the provision for an initial payment is important in the administration of the acts but it is not an essential part of a discussion on pooling.

Co-operative accounts are necessarily more detailed than those of a private trader or even of a commission merchant. The product may be graded upon delivery, or grading may be deferred until after a processing[1] operation. Statistical records must be kept of the quantity brought in and of the quantity and grade of processed product at the credit of each member. Pool sales accounts, as required by the arrangement, must be opened and the proper amounts credited to them, and expenses must be recorded. When any pool is sold out the settlement price is determined and credit given the producer in the accounting records. An accounting system that will reduce labour and yet provide adequate control and sufficient detail is to be desired.

Before any pooling arrangement is prepared careful consideration must be given to the type of product and the conditions under which it will be sold.

Shrinkage and Overrun—A number of products shrink in processing and a few gain. Where this change is not great or is at approximately the same rate for all producers, the result can be pooled and settlement made on the quantity delivered, e.g., honey and cream. Where the shrinkage varies considerably between producers, each producer should be responsible for his own shrinkage and though an initial payment may be made on the estimated yield, settlement should be made on the quantity of processed product, e.g., seeds, fruits and vegetables. If the product is perishable and the processing and grading are deferred until the time of sale, some system of allotment must be instituted so that each producer will have a proportional amount of product processed at the same time; thus the period of time during which the product is held in an unprocessed condition will be equalized. In the case of apples, each variety is usually marketed in turn and thus all growers of any one variety will have their fruit graded and packed at about the same time. With onions, some other form of allotment must be adopted and the arrangement should an-

[1]Processing may simply mean cleaning, sorting and packaging or any one of these operations.

ticipate and provide for a large amount of spoilage and waste in which event the system of allotment may have to be abandoned and settlement made on the estimated grade at time of delivery.

Sales Proceeds and Expense—It is essential that sales be reduced to a common basis. If it is the general custom to sell f.o.b. warehouse in a standard container—and some sales are made on a delivered basis or in a more expensive type of container in the expectation that the net return will be greater—the costs of forwarding or of the extra container should be deducted from sales and not included in the processing, carrying and selling costs. It is advisable to enter special charges of this nature in separate accounts to be transferred in total to the pool sales accounts at the end of the season immediately prior to closing the accounts. When statements are prepared it is informative to include one showing the gross amount realized, the amount of the several charges deducted and the net realization. During the 1939-40 season the Nova Scotia Apple Marketing Board sold a large proportion of their apples to the local processing plants from whom they received the barrels back, consequently all expenses for containers, transportation and marine insurance were deducted from sales as fresh fruit and the returns stated per barrel of "naked" apples. Where exports are resorted to in order to relieve pressure on the domestic market and not in anticipation of higher price returns, it might be advisable to reverse this procedure and to charge the forwarding costs or an agreed portion of them to expense and thus pool this cost over the sale of all the product. The content of the pool sales accounts and what items are to be included in processing, carrying and selling costs, should be clearly indicated in the pooling arrangement.

Simple Average—Where the grades for settlement and for sale are identical the simplest procedure is to open a pool sales account for each variety or type, grade and size to be credited with the quantity sold and the amount realized. When all of any variety, grade and size is sold the total amount is divided by the quantity and the average price per unit is determined and settlement made accordingly. Where the varieties, grades and sizes are numerous the amount of detail involved is great and special accounting forms and rulings become necessary. Where the pro-

duct pooled is an annual crop and the marketing period is lengthy, it may happen that low grade products will be sold on high markets and high grade products sold on low markets, thus resulting in the average price for settlement of the low grades being nearly equal or even higher than for the high grades. Eggs, poultry and Nova Scotia apples are usually settled for on the basis of a simple average price.

Blended Products—Where the grades for settlement and for sale are different it is impossible to use the simple average method of settlement. When honey is pasteurized and cream manufactured into butter the different grades are blended and no average price for settlement by grade can be established by sale. The practice is to establish arbitrary differentials between grades with a view to encouraging the production of high quality products and discouraging the production of low quality products. Sales proceeds are credited to one account and after adjustment for these differentials the balance is divided equally. At present eggs are being exported to England according to the grade requirements of the British Ministry of Food—15 lbs. and heavier per 10 doz., no single dozen less than 22½ oz. This pack includes "A Large" and the larger eggs from the "A Medium" grade. Settlement is made on the basis of domestic grades. In this instance settlement can be made on the basis of the differential established by sales in the domestic market and is not entirely arbitrary. Alfalfa seed, too, may be blended for sale. It may be impossible to establish a settlement price by sale on all grades and resort may have to be made to an arbitrary differential on those grades for which no price is established by sale.

Basic Grades—Wheat is bought and sold at prices established on the Winnipeg Grain Exchange for No. 1 Northern in store at Fort William. No. 1 Hard may sell at a slight premium over No. 1 Northern; all the other grades and types sell at a discount from this basic grade. When wheat of a grade or type other than No. 1 Northern is sold the amount that a similar quantity of No. 1 Northern would have realized is calculated and the amount of the difference is recorded in a special account. There need only be one sales account, but an account for the spread is required for each grade and type handled other than the basic grade. When the pool is entirely sold out and settlement is to be

made the average price as No. 1 Northern is determined by adding to sales the total discounts, deducting the premium and dividing this adjusted amount by the total number of bushels in the pool. The average premium and discounts are determined by dividing the amount of the spread for each grade and type by the number of bushels of that grade and type. Settlement is then made at the average price as No. 1 Northern plus the average premium or minus the average discount actually realized by sale. This calculation adjusts for the inequality that might result from lower grades being sold at high prices or vice versa, and the following is given as an illustration.

Calculation of Settlement for Wheat as No. 1 Northern in Store Fort William on basis of average spread realized by sale

1. Realized by sale (basis Fort William)	$90,953.00
Add Discounts from No. 1 Northern	996.00
	91,949.00
Deduct Premium over No. 1 Northern	1.00
Value as No. 1 Northern (basis Fort William)	$91,948.00
Number of bushels	127,000
Average as No. 1 Northern (basis Fort William)	$ .724

2.

Grade and type	Quantity	Spread		Settlement	
		Amount	per bus.	per bus.	Amount
	Bus.	$	Cents	Cents	$
No. 1 Hard	1,000	1.00	.10	72.50	725.00
No. 1 Northern	100,000	basic	basic	72.40	72,400.00
No. 2 Northern	15,000	331.50	2.21	70.19	10,528.50
No. 3 Northern	5,000	193.50	3.87	68.53	3,426.50
Feed Wheat	2,000	150.00	7.50	64.90	1,298.00
Tough No. 2 Northern	1,000	41.20	4.12	65.28	682.80
No. 1 C.W. Amber Durum	2,000	167.00	8.35	64.05	1,281.00
No. 2 C.W. Amber Durum	1,000	112.80	11.28	61.12	611.20
	127,000	$995.00	xx	71.62	$90,953.00

An annual pool for hogs is not feasible because of seasonal fluctuations in marketings and price. However, it is quite practicable to operate a weekly pool. Hogs are tatooed with the producer's number prior to shipment and after slaughter the carcass is inspected and "graded on the rail." The usual procedure is to determine the average price for the B1 grade for the week by adding back discounts and deducting the premium and dividing the amount by the total weight. Settlement is made at the weekly average price but each shipper is given credit for the actual premiums

earned and charged for the actual discounts on his own hogs.

Special Pooling Plans—In British Columbia it is the common practice to put the entire proceeds from the sale on one variety of apple into one pool sales account regardless of grade and size. Arbitrary differentials are used in order to make settlement. Thus the grower of high grade fruit is always assured of a premium even though the apples may not have actually realized a premium in the market.

Grades for ranch bred silver fox pelts depend on the colour-phase and the quality. Within each of these main grades there are sub-grades depending on the size of the pelt. In the pools that have been operated to date a basic valuation in dollars has been assigned to each sub-grade. For example, pelts in the Three Quarter Silver Fair Quality and Colour Pool had basic values of $28.00, $26.00, $24.00, $22.00 and $20.00 depending on size. By agreement one pool sales account has been kept for each of the main grades and the settlement price for pelts has been the percentage of the basic valuation of the pelt that the amount realized was of the total basic valuation of the main grade or pool. Assume that 20 pelts are in the Three Quarter Silver Fair Quality and Colour Pool—which for convenience is designated by a number—that the basic valuation of the lot is $472.00 and that they actually realized $377.60 or 80 per cent of the basic valuation. For settlement the large size, basic valuation $28.00, would receive 80 per cent of $28.00 or $22.40, the next size 80 per cent of $26.00 or $20.80 and so on for each of the sub-grades.

During 1939-40 the Nova Scotia Apple Marketing Board sold most of its apples to the processing plants at prices set by agreement with the Dominion government. Varieties were considered of equal value for processing—a few were discounted 25c per barrel—so the prices set in the agreement in no way reflected the usual value in the fresh fruit market. Under these exceptional conditions, to settle on the basis of price realized would penalize the grower of low yielding high priced varieties. Accordingly it was decided to settle on the basis of the average of the prices realized during the preceding three years. At the end of the season the number of barrels of each variety, grade and

size, in the pool was extended at these average prices and the total value determined. The amount of money available for distribution in the pool was approximately 65 per cent of this calculated value. Each variety, grade and size was settled for at this percentage of its three-year average price.

Where an arbitrary method of settlement is contemplated, such as described in the three preceding examples, it is extremely important that the terms be carefully arranged in advance and that proper publicity be given them so that each participant will know beforehand what he may expect as his share of the pool.

Processing, Carrying and Selling Costs—Sufficient expense accounts should be used to facilitate the preparation of a fairly detailed statement of costs. The number and nature of these accounts will vary with the nature and complexity of the processing and marketing operations. If special charges are deducted from sales, as has been suggested, it will likely be satisfactory to assess these costs at a rate per unit. In circumstances where a large proportion of the costs are dependent on value, e.g., interest, marine and war risk insurance, consideration might be given to assessing costs as a rate per unit and as a percentage of value.

The pooling of returns from the sale of agricultural products is a rather complex subject and this article is not intended to be a full discussion. It may stimulate some interest, however, in what is primarily an accounting problem and concerning which there is not much literature available.

THE SOURCE AND APPLICATION OF FUNDS STATEMENT

By J. D. Campbell, Chartered Accountant, Kingston, Ontario

UNDER *The Companies Act, 1934,* (Dominion) s. 112, ss. 1(a), (b) and (c) directors are required to lay before the company at each annual meeting:—

> (a) a balance sheet made up to a date not more than four months before such annual meeting: . . . .
>
> (b) a general statement of income and expenditure for the financial period ending upon the date of the balance sheet;
>
> (c) a statement of surplus showing separate accounts for capital surplus, distributable surplus and earned surplus respectively, the amounts of such surpluses respectively at the beginning of the financial period, adjustments affecting previous financial periods, net profit or loss as shown by the statement of income and expenditure, dividends paid or declared on each class of shares stating the account against which the same are charged, any other appropriations, changes in and balance remaining of capital surplus, distributable surplus and earned surplus respectively;

These statements which must legally be placed before the shareholders of a Dominion company disclose a current picture of the corporation's affairs. The balance sheet aims at a presentation at stated intervals of a static picture of the corporation's position broken down as between the assets over which the company has control and the counterbalancing equities in these assets sub-divided between creditorship and ownership. The operating statement and surplus accounts give a summary of the changes arising from the company's operations for the period lying between the two corresponding consecutive balance sheets.

The actual change in the composition of the individual assets and equities during a given period is not disclosed either by the operating statement or the surplus account. This information can only be obtained from two consecutive balance sheets. "Usually . . . . operations not only produce a change in total net assets but also a change in the character of assets—for conversions are hardly likely exactly to replace themselves in kind. . . . . The purpose of the summary of balance sheet changes is to show just this so that we may see whether we have more or less of the desirable things."[1]

[1]Cole, W. M., *The Fundamentals of Accounting*, p. 347.

The average layman finds it difficult to bring the information presented on the various statements into a composite picture which is at all intelligible. From the comparative balance sheets taken as at the beginning and the end of a period, the individual increases and decreases in assets and equities can be calculated. The operating statement for the period discloses in part the causes underlying these changes and this information may be combined with the balance sheet changes to form a composite statement. To this composite statement has been given the heading of "Source and application of funds statement."

R. H. Montgomery of New York, in discussing the statement says, "Although a comparative balance sheet indicates the increases and decreases in assets, liabilities, and net worth during a given period, it does not explain how the additional funds were received and used during that time. With the aid of a comparative balance sheet and certain additional information, a statement of application of funds, when properly prepared, will show the changes in financial condition, the sources of additional funds, and how these funds were used. . . . . The statement of application of funds provides information regarding the changes in the financial condition of the business, the source from which additional funds have been obtained and the disposition thereof. The comparative balance sheet although serving its purpose falls short of furnishing this important information."[2]

George O. May, F.C.A., of New York, in an address "Wider Horizons," discusses this statement and claims that it "answers the vital question—what has become of cash?—and affords a useful corrective to views formed on the basis of an income account which unduly emphasizes net earning capacity as distinguished from net current receipts." As the statement in the form customarily presented reflects changes in items other than cash, it can hardly, as stated in the above quotation, be considered in the nature of a cash statement of receipts and disbursements. It is rather a statement disclosing the factors underlying the changes which have occurred in the working capital. It includes not only resources which have been converted into the form of cash during the present period (cash statement) but

[2]Montgomery, R. H., *Auditing Theory and Practice* (v ed.), p. 680-2.

also the acquisition of new current resources which may be converted into cash during the subsequent periods. In setting out his opinion as to the position of importance of the statement Mr. May states, "I should not be at all surprised if in a few years instead of the old-fashioned concentration on the balance sheet, the order of importance will be something like this: first the income account . . . .; second the statement of quick assets and liabilities; third a statement of changes in reserves; fourth a statement showing the resources which have become available during the year and the disposition of them . . . . After these four I think the balance sheet will come in the fifth position."[3]

The source and application of funds statement not only discloses the composite picture required by the ordinary layman in intelligently interpreting a given company's operations, but may also be used significantly both in interpreting and disclosing management policy and as a tool for economic analysis.

Preparation of Statement

The preparation of the source and application of funds statement has already been treated by numerous writers in accounting texts and the average accountant is no doubt familiar with the technical difficulties involved in the task. No attempt will be made to discuss this aspect in detail although certain significant facts as to book entries and reported net profit might be mentioned as well as the limitation placed on the preparation of the statement by the amount of available information.

As the source and application of funds statement is a "working capital" or "funds" statement it would not disclose changes arising from transactions which do not involve funds or resources. An example of such changes would be the writing up of the valuation of the fixed assets and the creation of an appraisal surplus resulting from an appraisal. "All book entries not involving the receipt and outlay of current funds are eliminated."[4]

In arriving at the reported figure of net profit arising from the company's operations, certain charges are usually made which necessarily affect the net profit, but do not

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[3]From an address by George O. May entitled *Wider Horizons* reproduced in *The Canadian Chartered Accountant*, vol. XXX, p. 302.

[4]Daniels, *Financial Statements*, p. 73.

involve the utilization of liquid resources by the management. This applies to such items as depreciation, amortization of bond discount, etc. In order to set forth an accurate picture of the resources or funds which have become available to management as a result of the company's operations such charges must necessarily be added back to the figure of reported net profit assuming that such a figure for net profit is after providing for such charges.

The accountant in preparing the source and application of funds from his client's records does not encounter the difficulty of a scarcity of information. Except for certain technical difficulties involved it is a relatively simple task for him to prepare such a statement. Other persons who have available only the limited information provided in the data presented by public companies in their published statements encounter numerous difficulties in any attempt to prepare such a statement due to a scarcity of information. This is revealed in both content and terminology.

Although the form of the published statements is at present far from ideal, the accounting profession has accomplished much in the past decade in the presentation of published statements which are not only more informative as to content, but also more concise as to terminology. This has been achieved mainly through the accountant's daily contacts and by public pressure for improved legislation. One of the outstanding results of the pressure for improved legislation was the requirements as to content incorporated in *The Companies Act, 1934* (Dominion) and the subsequent revision of 1935.

> The said statement of income and expenditure shall show separately net operating profit before depreciation, obsolescence and depletion and income taxes; income from investments; . . . . Provided that where depreciation, obsolescence and depletion are charged against manufacturing or operating costs by the company in its accounts, net operating profit may be shown after depreciation, obsolescence and depletion, if the amount charged in respect of those items for the financial period is shown as a footnote to the statement of income and expenditure.[5]

The failure of certain companies to present the relevant information as to the amount of depreciation charged yearly in the accounts prior to 1934 renders it impossible to carry on any investigation involving this figure prior to this date

[5]*The Companies Act, 1934,* (Dominion), Sec. 113, s.s. 3.

for other than a relatively few concerns. It was only after the legislation of 1934 came into force that Dominion incorporated companies were legally required to present such information as to the amount of depreciation charged to operations in its accounts for a given period. It might be mentioned that in the majority of cases it was not until legally required that the companies presented this information.

Interpretation of Management Policy

The usefulness of the source and application of funds statement has gained wide recognition as a means of interpreting and disclosing management policy. It is used not only as a means of disclosing to management the results of their operating policies, but also as a method utilized by executives for submitting more informative and intelligent information to the shareholders.

The customary items of information revealed on the source and application of funds statement are as set out below:

Source and Application of Funds Statement

Source of Funds

Net profit after depreciation
Depreciation charged against operations
Proceeds of new issues of securities

Application of Funds

Cash dividends paid
Purchase of fixed assets
Investment in and advances to subsidiary companies
Redemption of outstanding securities
Increase in working capital

A comparison of the individual items appearing on the statement and relationships existing between the respective items over a series of years reveals interesting relationships which act as indicators of general management policy. If an examination of the information presented on the statement prepared for a series of years disclosed widely fluctuating earnings with a corresponding fluctuating depreciation provision, it would appear, other things being equal, that the company's depreciation policy was governed by the

exigencies of the time rather than by any accounting concept as to the nature of depreciation. If an examination revealed a close correlation between the trend of net profit and the purchase of fixed assets, it would indicate the psychological effect of increased earnings or improved business on management in respect to its policy as to new investment and replacement expenditures.

The following excerpts taken from the presidents' reports to the shareholders of two Canadian companies for the year ended 31st July 1940 serve to illustrate the use of the statement or the information which it presents by executives in interpreting the company's operations for the year to the shareholders.

Company A

The working capital position improved during the year by $298,218.12 as follows:

Profit from operations and income from investments less interest, income taxes, etc., but before providing for depreciation		$567,220.40
Less: Net expenditure on additions to plant and machinery and for the purchase of trucks and automobiles	$182,963.53	
Cost of company's own bonds purchased for sinking fund	86,038.75	269,002.28
		$298,218.12

Company B

The following is a summary showing the disposal of the consolidated operating profit:

Reduction City of . . . . loans	$ 41,429.34
Interest City of . . . . loans	23,328.23
Provision for Dominion and provincial income taxes (including estimated excess profits tax)	123,532.55
Dividends on 5¼% preferred stock	77,529.97
Dividend on common stock	52,318.00
Net expenditure on fixed assets	37,706.33
Redemption of 479 shares preferred stock	23,950.00
Increase in working capital	143,577.12
	$523,371.54
Less: Decrease in other assets	1,260.41
	$522,111.13

The above quotations taken from the published reports are not drawn up in the regular form of the source and

application of funds statement but nevertheless they do give significant information as to the concerns' operations which is of interest to the shareholders. In both cases the information presented is somewhat distorted as a result of the terminology used. In the first instance the term working capital includes investments in and advances to controlled companies and sundry assets whereas in the second example the "consolidated operating profit" includes a profit on redemption of preference shares of $1,369.13 and is also shown before charging depreciation, interest on funded debt, and Dominion and provincial income taxes.

An examination of the following statement prepared from the published balance sheets and surplus account of the company referred to in the second example will tend to disclose the extent to which the actual source and application of funds statement would have been more informative than the extract submitted.

B Company Limited

Source and Application of Funds Statement for the year ended 31st July 1940

Source of Funds

Net consolidated profit after provision for depreciation and provincial and Dominion income taxes		$240,662.33
Add: Charges made to operations not involving an outlay of funds—depreciation		133,218.89
Funds made available from the company's operations		$373,881.22
Sinking fund cash in bank		3,309.83
Proceeds from the disposal of land (net)		100.00
Decrease in prepaid expenses		3,275.58
		$380,566.63

Application of Funds

Payment of cash dividends		
Preferred	$77,529.97	
Common	52,318.00	$129,847.97
Purchase of fixed assets (net)		37,806.33
Redemption of deferred liabilities (City of . . . . loan)		41,429.34
Redemption of preferred shares		22,580.87
Increase in outstanding mortgages receivable		5,325.00
Increase in working capital[6]		143,577.12
		$380,566.63

[6]This item is customarily supported by a schedule indicating in detail the changes in the various items entering into the working capital.

Important as the source and application of funds statement may be for the information of the management, as already outlined, it appears that it has a still more expressive use, the possibilities of which have apparently not yet been realized. This is in the budgetary field. If the statement is such a significant tool in analyzing past management policy there does not appear to be any reason why it cannot be applied as efficiently in disclosing effects of future management policies indicated in the budgetary program.

Tool for Economic Analysis

The use of the statement of source and application of funds in the field of economics is still in its infancy. In recent years economists have been increasingly interested in the activities of business men as reflected in accounting records. This is indicated in the recent investigation of the Temporary National Economic Committee of Congress of the United States into the question of savings and investment. In the hearings which took place before this committee, business men such as Alfred P. Sloan, chairman of the Board of General Motors Corporation, and Edward R. Stettinius, chairman of the Board of The United States Steel Corporation, were called upon to translate business activities as reflected by their accounting records into a form which would bring out the facts which were of significance to the economist. To meet this requirement the source and application of funds statement was used. This statement has not as yet been applied extensively in economic analysis, but it is of great importance in providing relevant information in respect to both corporate savings and investment.

Taken collectively for the Canadian economy the facts presented on the source and application of funds statement bear added meaning to the economist especially when they are made available for a series of years. Information will then be made available which will provide the answer to questions of corporate savings and management policies and their economic effects as reflected in the national income and the business cycle.

The content of the information provided in this statement is by no means limited to the above suggestions. It is only when this information has been compiled for the Canadian economy as a whole that the potential value of the statement will be realized.

THE CANADIAN FEDERAL SALES TAX

By William H. Wynne[1]

University of Michigan, Ann Arbor, Mich.

IN CANADA the sales tax is almost exclusively a federal levy, for at lower levels of government it is used by only two provinces (Saskatchewan and Quebec) and two cities (Montreal and Quebec). Moreover, while these provinces and cities employ retail sales taxes of the familiar type,[2] the Dominion imposes a distinctive tax, limited to sales by manufacturers. The Dominion levy has attracted much attention abroad, and, indeed, officials familiar with its operation have been loaned as advisers to a number of countries contemplating the adoption of a similar measure. Australia, for example, aided by such co-operation from Canada, instituted a federal sales tax in 1930, and although the Commonwealth levy is imposed mainly upon sales by wholesalers, sales by manufacturers being taxed only when made at retail, it is none the less patterned upon the Dominion measure. The Purchase Tax, recently instituted by Great Britain under the exigencies of war, bears sufficient resemblance to the Canadian and Australian levies to justify the assumption that its adoption was preceded by a careful examination of these levies. That official circles in this country, too, have had occasion to study the working of the Dominion sales tax may be taken for granted, for while no federal sales tax has been instituted, it was to the Canadian system that Congress turned in 1932 for a pattern when the adoption of a federal sales tax was under consideration by that body. These circumstances notwithstanding, for information beyond the barest outlines of the form and scope of the Dominion sales tax one must still go to statutes and regulations. The present paper, it is hoped, may meet the need for a concise and up-to-date account of the development, nature, and operation of this interesting levy.

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[1]The writer was during the year 1937-38 a member of the research staff of the Canadian Royal Commission on Dominion-Provincial Relations. This paper is based upon a study made by him for the Commission and was prepared for and published by *The Bulletin of the National Tax Association* (October 1940), to which we make grateful acknowledgment.

[2]Montreal instituted a sales tax in 1935, Saskatchewan in 1937, the province and the city of Quebec in 1940.

Changes in Form and Amount of Tax

In the form in which it was first introduced in May 1920, the Dominion sales tax extended to the sales of wholesalers as well as of manufacturers. At the outset no distinction was drawn between sales made by a manufacturer to a wholesaler and those made direct to retailers or consumers, each class of sales, as well as sales by wholesalers, being taxed at 1 per cent. Protests were raised that an incentive was thereby afforded the manufacturer to by-pass the middle man, and, in consequence, the government, within a month, amended the tax so as to subject such direct sales by manufacturers to a double rate of tax, namely 2 per cent. An analogous modification was at the same time made in the sales tax on imports. Originally established as a uniform levy of 1 per cent, on importations by retailers and consumers the rate was advanced to 2 per cent, in order to place them on an equal footing as regards taxation with other classes of importers who were required to pay a tax of 1 per cent upon the sale of foreign goods as well as a 1 per cent tax upon their import.

Four classes of transactions were accordingly established: first, sales by manufacturers to wholesalers and sales by wholesalers, taxed at 1 per cent; second, sales by manufacturers to retailers or consumers, taxed at 2 per cent; third, imports by manufacturers and wholesalers, taxed at 1 per cent; fourth, imports by retailers or consumers, taxed at 2 per cent. The rates were advanced in 1921, and raised still higher in the following year, at which time they became 2¼ per cent, 4½ per cent, 3¾ per cent, and 6 per cent respectively. As part of the upward scaling of the rates in these years the import rates were advanced in 1921 1 per cent and in 1922 1½ per cent above those of the corresponding domestic rates, allowance being made in this way for the fact that more than one sales tax was included in the finished article made in Canada, while the materials entering into the manufacture or production of the foreign article were not subject to any such tax.[3] On exports no sales tax was required; tax exemption was also granted on domestic sales in respect of many commodities, including

[3]Dominion Budget Speech (Sir Henry L. Drayton) May 9, 1921.

raw food stuffs, fuel and power. Lumber, though not exempted, was favoured by a concession in rates.[4]

While the tax was under consideration, and during the first years of its operation, various commercial organizations, as well as prominent individual leaders in business and finance, advocated the extension of the tax to retailers so as to make it a turnover tax applicable to the gross receipts of all classes of business. The main argument advanced in favour of the proposed tax was that it would produce considerably more revenue, even at lower rates, than the existing sales tax, and so make it possible for the government to reduce income tax rates in the higher brackets.[5] While conceding that "theoretically, a general turnover tax on commodities and services (had) much to commend it," the Minister of Finance (Sir Henry L. Drayton) in his budget speech of 9th May 1921 dismissed the proposal by pointing out that "in view of the fact that .... books are not kept in many retail stores, the cost of administration would be unduly great and difficulties of collection many."

Soon criticism of another order was leveled at the tax.

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[4]For lumber the rates were set in 1922 at 3 per cent on domestic sales and 4½ per cent on importations, but one rate being established —instead of two as for other taxed commodities—in respect of each class of transaction. For other taxed commodities the higher rates were, as noted above, upon domestic sales 4½ per cent and upon imports 6 per cent.

[5]This argument was repeatedly advanced, for example by the late Sir Edmund Walker, President of the Canadian Bank of Commerce when presenting the annual report of the Bank. Thus in 1922 (see Annual Report of the Bank of Commerce, November 30, 1922) he declared: ". . . the turnover tax is one of the least complicated and most easily collected of taxes. Canada is frequently complimented by students of taxation in the United States and Great Britain on its sales tax, but a much larger revenue, in a form much less hurtful to production, would result from a turnover tax of one per cent. Such a revenue would make it possible to lessen the scale of super-taxes now imposed on incomes and other unfair taxes on enterprise, the ruinous result of which is evident to all who give any thoughtful attention to the matter."

Again, at the tenth annual meeting of the Ontario Associated Boards of Trade and Chambers of Commerce held at Hamilton, November 15-16, 1923, a resolution was passed declaring that "the sales tax as at present administered is not sufficiently broad in its operation and does not produce the revenue which it should," and advocating, *inter alia*, a turnover tax. Dislike of direct taxation was implied in the concluding passage of the resolution which urged that "the ordinary expenditures of Canada should be met, as was the case before the war, from customs tariff, inland revenue, and such other forms of Federal Taxation as existed at that time."

It was complained, not that the tax was too narrow in its scope, but that it was too wide, and that it lent itself in consequence to pyramiding. The tax was payable, for example, on the sale of leather by the tanner to a shoe manufacturer, on the sale of the shoes by the shoe manufacturer to the wholesaler, and again on the sale by the latter to the retailer. To remedy this situation the government, on 1st January 1924, replaced the tax by one designed to apply once only. The new levy was confined to importations and to sales by the final manufacturer. Iinitiated at 6 per cent, it was reduced in April 1924 to 5 per cent, in 1927 to 4 per cent, in 1928 to 3 per cent, in 1929 to 2 per cent, and in 1930 to 1 per cent. These successive cuts in the tax had been foreshadowed by the Liberal Minister of Finance (Hon. James A. Robb) who in 1926[6] stated in the House that the government planned to get rid of the sales tax but to eliminate it gradually, by reductions of say 1 per cent a year, in order to avoid hardship to dealers holding large stocks of tax-paid goods. Thanks to a marked expansion of economic activity, which led to a considerable growth in the customs revenue with no offsetting rise in federal expenditure, the government almost succeeded in fulfilling its undertaking. But by 1930, when the rate had been brought down to 1 per cent and the complete abolition of the tax seemed at hand, the tide of prosperity had begun to recede, and the Conservative party, which was returned to power in the summer of that year, and which, while in opposition, had deprecated the tax and urged the government to speed its withdrawal, found itself in the unfortunate position of having to maintain and enhance the levy. With expenditure rising and customs receipts contracting rapidly, the new Conservative government felt itself impelled to exploit the sales tax as a ready and dependable means of quickly and substantially supplementing revenue. In 1931 the tax rate was raised from 1 per cent to 4 per cent, while a year later another 2 per cent was added; by these swift moves the 1924 level of 6 per cent was thus restored. Under the continuing impact of the depression the Liberals in their turn found it necessary in 1936, a few months after they had regained office, to advance the rate to 8 per cent, at which high level it has since been held.

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[6]Hansard, 1926, Vol. IV, 9, 3743.

The sales tax has proved a highly elastic source of revenue. Rate increases in the intermediate years pushed the yield up from $38 millions in 1920 (the initial year of the tax) to $98 millions in 1923. The narrowing of the tax base at the beginning of 1924, and the 1 per cent cut in the rate which quickly followed, reduced the yield for that year to $63 millions, but with business recovery the yield rose in 1926 to $81 millions. From this point there was an accelerating decline as the rate was brought down step by step from 5 per cent to 1 per cent, until in 1930 the tax produced no more than $20 millions. Due to the persistent decline in production and in the price level the sharp rate increments of the ensuing two years failed to exercise a proportionate effect on the yield of the tax, and although in 1932 the rate was six times as high as in 1930 the proceeds were less than three times as great ($57 millions). Improving economic conditions, accompanied by the increase in the rate in 1936 from 6 per cent to 8 per cent, enlarged the yield considerably, and in 1937 a peak of $138 millions was reached, an amount equivalent to 27 per cent of the total current revenue of the Dominion.[6a]

Collection and Administration[7]

For the collection of the tax the Customs and Excise staff, augmented as the need has arisen, has from the be-

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[6a]The major importance of the sales tax as a source of Dominion revenue is revealed by the table below, taken (with some rearrangement) from the Budget Speech delivered by the Dominion Minister of Finance (Hon. J. L. Ralston) on June 24, 1940.

Dominion Current Revenues for the Three Fiscal Years 1937-38 to 1939-40

(In Millions of Dollars)

	1937-38	*1938-39*	*Estimated 1939-40*
Sales Tax	138	122	137
Income Tax (Persons & Corporations)	120	142	134
Excise Revenues	95	91	90
Customs Duties	93	79	104
Other Taxes	2	2	2
Non-Tax Revenues (Gross)	62	62	74
Total Current Revenues	510	498	541

[7]For most helpful replies to my many troublesome questions concerning the administration of the tax I am greatly indebted to Mr. V. C. Nauman, the Assistant Commissioner of Excise, Ottawa.

ginning been utilized. The sales tax is accordingly collected by officials simultaneously engaged in the collection of customs duties and excise levies. Audits of sales tax and excise taxes are likewise carried out by the one body of auditors. The department does not attempt to apportion its staff costs and other expenditures among the various revenue services performed, so that the precise cost of collecting the sales tax is unknown. Since no larger staff is needed to collect a high tax than a low one, the cost of collection—in terms of a percentage of the yield—tends to vary inversely with the rate. At the present rate level, it may be safely asserted, the sales tax costs the government less than 1 per cent to collect.

Every manufacturer or producer of taxable goods is required to take out and renew annually a sales tax license, for which he pays a yearly fee of $2.00. With a complete list of licensees in its files the Department of National Revenue quickly becomes cognizant of any tax delinquency. The tax due on each month's sales must be paid before the close of the ensuing month, subject to an interest penalty of 8 per cent for further delay.

Licensees pay the tax to the local inspector of customs and excise, reporting their tax obligation on a form which calls only for a statement of the total amount of taxable sales for the preceding month, without any itemization. A manufacturer selling only taxable products, whether he deals solely with buyers from whom the tax must be collected, or in part with tax-free purchasers, can supply this information readily from his ordinary business records, and to him the cost of tax compliance is trifling. But to the extent to which he sells to non-licensees (i.e., those from whom he must collect the tax) tax exempt as well as taxable articles his task becomes more burdensome. In respect of such sales the separate invoices must be analyzed in order to arrive at the amount of taxable sales, thereby adding to the cost of tax compliance.[8] The probability is, however,

[8]Where a manufacturer sells taxable products to retailers he is required to pay the tax only on the wholesale price of the goods as determined for the purpose of the tax by the Department of National Revenue.

Similarly, where a manufacturer, instead of selling his products to the wholesale trade or to the retail trade, sells direct to the consumer, the Department will fix a value on which the manufacturer may account for sales tax.

that to the majority of manufacturers this cost is quite small.

At the end of 1924 the body of auditors numbered no more than 36. The force has now (August 1940) grown to 140, added to which 19 officers are at present employed in conducting special investigations and in directing the audit work generally. Notwithstanding this considerable expansion, the audit staff, it would appear, is still comparatively small for the work which devolves upon it, for there are over 23,000 sales tax licensees in the Dominion, while, as mentioned above, the sales tax auditors are also auditors of excise tax payments. Under these circumstances it is not possible for an auditor to inspect the books of all the licensees in his district even once a year, and in many instances audits are made only at intervals of two years or more. The visits of the auditor may be as short or as prolonged as circumstances require. He usually samples, taking, for example, the checks for one or two months. If he finds anything incorrect, he is likely to enter upon a more detailed audit and to lengthen his stay accordingly.

The basic principle of the Dominion sales tax is that goods shall be taxed only as they leave the hands of the final manufacturer in the process of fabrication to enter into the channels of distribution. Manufacturers are accordingly permitted to purchase free of tax the raw materials and partly manufactured goods which are to be "used in, wrought into or attached to" their finished taxable products. Besides the materials incorporated in the finished article, the containers, labels, wrappings, etc., used in shipping it are also under this provision tax-exempt. When buying such tax-exempt materials, the manufacturer must give his license number and certify on his purchase order that they are "to be used in, wrought into or attached to" taxable articles for re-sale. Wholesalers are not required to take out licenses, but if they are selling to manufacturers goods for further processing, it is to their advantage to do so, for they are thus enabled to buy such goods and sell them without payment of sales tax.

Materials which are to become constituent elements in a finished product have from the beginning been purchasable by licensees tax free. But on two other closely related classes of commodities the payment of tax has at some periods been required and at others not. These two classes

are, in the language of the Act: (1) "Articles and materials, not to include permanent equipment, which enter into the cost of manufacture or production of goods manufactured or produced by a licensed manufacturer or producer." (2) "Materials not to include plant equipment, consumed in process of manufacture or production, which enter directly into the cost of goods subject to the consumption or sales tax, manufactured or produced by a licensed manufacturer or producer." The first group, which may be termed "non-permanent equipment," was, prior to 15th April 1926, taxable; exemption was then enjoyed until 21st March 1933, when tax liability was again established. The second group, conveniently denominated "consumables," after being taxable until 10th April 1924, became exempt until 21st March 1933, then again taxable until 1st May 1936, following which exemption was once again conceded. The two groups were thus simultaneously exempt from 16th April 1926 to 21st March 1933, and simultaneously taxable prior to 21st April 1924 and from 22nd March 1933 to 1st May 1936. From 11th April 1924 to 16th April 1926, non-permanent equipment was taxable but consumables exempt, and since 2nd May 1936, the same situation has obtained. There have thus been two periods when it has been to the interest of manufacturers to have a given article classified as a consumable rather than as non-permanent equipment. In many instances the proper classification for an article is a matter of doubt, and interested parties have naturally felt dissatisfied and aggrieved when materials which they submitted ought reasonably to be tax-exempt as consummables, have been ruled to be non-permanent equipment and therefore taxable.

Comprised under the heading non-permanent equipment, and currently taxable, are some hundreds of articles, including small tools of all kinds, dies, abrasives, and a variety of polishing and lubricating materials. Consumables, at present tax-exempt, also make up a lengthy list of some 300 items, for the most part chemicals. These items are specified as exempt when used in particular industries. Without an affirmative ruling to that effect, it is not certain that they will be exempt when used in other industries.

Perhaps no harder task has been placed on the authorities administering the sales tax than that of distinguishing between the two categories, and at times the decision must

seem to many arbitrary. Thus while lubricating oils,[9] abrasives, and polishing materials of various sorts have been held to be non-permanent equipment—or to use an alternative term, "factory expense material," among consumables are included, when used in the production of metals or the manufacture of metal products, such materials as the following: cutting oil and threading oil, cutting and grinding compounds, and acids used for cleaning metal before plating, tinning, or galvanizing. Sand paper, which manufacturers claimed to be a consumable, was ruled by the authorities to be a factory expense item. Often, as these examples illustrate, no clear line of demarcation between the two groups can be drawn. The decision in doubtful cases involves a judgment of the administrative authorities that the material under consideration is or is not physically consumed in the process for which it is used. If the decision is an affirmative one, the article is held to be a consummable, otherwise not. The fact that a material is worn away by use does not, in the eyes of the authorities, make it a consumable. It is for this reason that sand paper, for instance, was excluded from consumables. If exemption were granted for sand paper, it was asked, why not for similar cutting and polishing materials, or even for grinding wheels?

Considerable difficulty has also at times been experienced in distinguishing between articles that are consumed in the process of manufacture and those which are incorporated in the finished goods. The latter, as previously mentioned, have always been exempted, the former only at certain periods.

For the consideration of questions such as these a Rulings Section is maintained within the Excise Division of the Department of National Revenue, comprising eight officials, each dealing with a particular group of commodities. If, after consideration by this Section, a case still remains in doubt, it is referred to the Assistant Commissioner, who may, on occasion, find it necessary to consult with the Commissioner before reaching a decision. The rulings are made as expeditiously as possible and are based solely on the merits of the case, revenue considerations never being allowed to enter.

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[9]Under an amendment of May 2, 1936, lubricating oils are statutorily excluded from consumables.

Appeals from the rulings of the Commissioner may be made, at the option of the parties, to either the Tariff Board or the courts. No appeal lies from the Tariff Board to the courts or vice versa. A considerable number of appeals have been taken to the courts but, hitherto, only twenty-one appeals growing primarily out of sales tax disputes have been submitted to the Tariff Board.[10] The cases laid before the Tariff Board have all raised the issue whether a given article was or was not liable to sales tax. Those taken to the courts have, of course, also evoked the question of tax liability, but usually in connection with more complicated situations. Prominent among the questions appealed to the courts has been the validity of certain devices to which, as the tax rate has risen, taxpayers have resorted in order to lighten the burden. One of these devices most frequently met with in the past, and one which is undoubtedly still to some extent employed, is the splitting up of a business into two ends jointly managed and owned, one of which sells or transfers its goods to the other, paying the sales tax on the prices arranged between them. "The Department has always held that this was merely 'two pockets of one pair of pants' and that the transactions between companies arranged in this way would not be considered bona fide sales, unless the transfers were made at the prices at which either of them sold the goods in the regular and ordinary course of their business to independent purchasers."[11] The courts have followed this ruling in a number of cases, for example, that of the Colgate-Palmolive-Peet Company decided by the Supreme Court of Canada on 10th February 1933.

Exemptions

Until 1931 provision existed in the Act for the exemption of articles by Order-in-Council, but this power was seldom used by the executive and was removed in that year. Practically all amendments respecting exemptions have been made by authority of the legislature after debate in parlia-

[10]Prior to May 1, 1933, when the Tariff Board took over the duties and functions of the Board of Customs, appeals in sales tax issues could be made before the latter body. The number of appeals mentioned above does not include appeals heard on customs duty issues where sales tax was a secondary question.

[11]From an address by Mr. V. C. Nauman, Assistant Commissioner of Excise, reproduced in part in the *National Revenue Review* (Ottawa) December 1934, page 15.

ment. When the Act prescribes that "consumables," sugar, etc., shall be exempt, it is for the Excise Division to make rulings as to which articles are, within the meaning of the Act, "consumables," or as to whether maple butter and maple taffy (to cite a question appealed to the Tariff Board) are classified as sugar. Beyond this the Division does not go. In carrying out the Act it interprets terms used in it but makes no changes in the schedule of exemptions. The Division, in other words, is purely an administrative, not a policy-making, body.

The length of the list of exempt articles has varied, unlike the rate of the tax, inversely with revenue needs. Down to 1931 the number of exempt articles was gradually increased; subsequently a considerable reduction was made.[12] Outstanding among the revisions dictated by revenue considerations was the withdrawal of exemption in March 1931 from both non-permanent equipment and consumables. In addition to the removal from the exempt list of many other commodities of wide sale, such as molasses, corn syrup and sugar, cane syrup, cleaned rice, sago, and tapioca, several articles previously taxed at only half the full rate were made taxable at the full rate. The policy of singling out particular commodities for taxation at a reduced rate, initiated by the concession to lumber in 1921, was continued under the readjusted sales tax by the establishment of a schedule of articles subject to only 50 per cent of the ordinary rate of tax. The half rate list was extended, concurrently with the increase in exemptions, and in 1931 embraced two groups, of which the first was relieved of half the tax either when produced in Canada or imported, and the latter only when produced in Canada. In the first group were included boots and shoes, biscuits of all kinds, creosoted railroad ties, printing paper for certain uses, moist mince meat, and yeast. The second group consisted mainly of canned fruits and vegetables, and in respect of these the reduction of the tax on the domestic product to half that on imports provided a subtle method of increasing the protective tariff without

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[12]The shrinkage in sales tax revenue from 1926 to 1930, while primarily attributable to the successive reductions in the tax rate, was also to some degree due to the increase in exemptions. Similary, the expansion of the revenue during the depression years, though chiefly caused by the rate advances, was also in a measure brought about by the curtailment of exemptions.

specific tariff legislation.[13] By the amendment of 1933 both groups of articles were in their entirety made subject to the full rate of tax. Taxation at the half rate is at present confined to articles produced in Canada by the blind[14] or by the deaf and dumb[15] in institutions established for their care or under the control or direction of such institutions.

Even now the list of exemptions extends to seven closely printed octavo pages. The exemptions include many essential food stuffs, the products of the farm and forest when produced and sold by the individual farmer or settler, a variety of commodities used for agricultural purposes, certain kinds of machinery and equipment employed in farming, logging, or mining, fishing boats when purchased by individual fishermen for their own use, hospital supplies, books of a particular nature—such as religious books, text books authorized by any provincial department of education, and books imported for the use of libraries — newspapers, unbound magazines, electricity, gas, and non-liquid fuel, etc.[16] The exemption of articles sold by, and to a large extent of equipment purchased by, farmers and other purchasers of primary products serves many purposes. It has spared the administration the extremely difficult task of keeping under surveillance the transactions of tens of thousands of small enterprises,[17] made the tax politically more acceptable, and afforded some encouragement to the basic primary industries. Moreover, such exemptions, in conjunction with the exemption of essential food stuffs by

[13]A similar element of protection was introduced via the sales tax in 1931 and 1932 by amendments adding to each of the words "lard," "hops," and "salt," in the schedule of exemptions, the phrase "when produced in Canada." As a consequence the exemption, which had previously applied (as in the case of all other exempted commodities) on the imported as well as on the domestically produced article, became confined to the latter alone. The tariff-making phrase was deleted in each instance in 1936, leaving the three commodities again exempt, whether imported or produced at home.

[14]Amendment of 1932.

[15]Amendment of 1935.

[16]In September 1939, however, under the pressure of war revenue needs, exemption was withdrawn from electricity and gas "used in dwellings."

[17]For the same reason Section 95 of the law (The Special War Revenue Act, Part XIII, "Consumption or Sales Tax") provides that "the Minister may . . . . direct that any class of small manufacturer or producer selling his product exclusively by retail shall be exempt from payment of consumption or sales tax on goods manufactured or produced by him and persons so exempted shall not be given a license."

whomever sold, and of electricity, gas,[18] and fuel, have excluded the sales tax from a considerable part of the average household's necessary expenditure, and so ameliorated the regressivity of the tax.

Incidence of the Tax

The popular view of the incidence of the tax is that it is pyramided until by the time an article reaches the consumer the tax has swelled from 8 per cent to a much larger figure, say 12 per cent, 16 per cent, or even more. The reasoning is as follows: the wholesaler pays the manufacturer a price which includes the tax.[19] The wholesaler accordingly regards the tax-included charge as his cost price, upon which he bases his profit. The retailer, in his turn, adds his 'markup' to the price he pays the wholesaler. At each stage in the process of distribution from the manufacturer to the consumer the dealer's profit is added to the tax, which has become concealed in the cost. Even if it is conceded that this is what actually occurs, a simple arithmetical illustration will reveal that the common view of the consequence of tax pyramiding is erroneous. Suppose that, in the absence of a sales tax, an article is sold by a manufacturer for $1 to a wholesaler, who resells to a retailer at an advance of 25 per cent, who then disposes of it to a consumer after a markup of 40 per cent: the price to the consumer becomes $1.75. Now introduce the Dominion sales tax of 8 per cent and allow the wholesaler and retailer the same markups, but on the tax included price, as before: the consumer must now pay $1.89 for an article which, in the absence of the tax, would have cost him $1.75. The rise in price amounts, it is true, to 14 cents, but this sum represents an addition of only 8 per cent, and no more, to the old tax-free price.

But the popular view of the incidence of the tax involves a more serious error than that exposed above. The middlemen's markups must cover all costs of distribution, including rent, labour, and expenses of management, as well as inter-

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[18]But see note 16.

[19]The law and the Department leave the manufacturer free either to show the tax as a separate item in his invoice or to state merely the tax-included price. The probability is that the majority of manufacturers adopt the latter course. Some of them have contended that were they required to itemize the tax, the work and expense of tax compliance would be doubled.

est on capital invested. A markup of 25 per cent or 40 per cent may provide for only a modest return on capital, a return which, granting competitive conditions, cannot be maintained at a higher level than that obtainable from other forms of investment involving a similar degree of risk. The cost to wholesaler and retailer of distributing a given unit volume of sales is enhanced by the sales tax only to the extent of the interest charge on the additional capital which the tax makes it necessary for them to employ. The popular view assumes, though, that on this additional capital the wholesaler can earn 25 per cent and the retailer 40 per cent.[20] Competition among existing middlemen and an influx of newcomers would, however, tend gradually to force down the return on the extra capital drawn into use by the tax to the normal competitive level, say 5 per cent. In so far as tax enhanced prices may restrict sales in given fields, competition will not preclude the middlemen affected from adjusting prices so as to cover the increase in overhead costs per unit sold attributable to the reduction in the volume of sales, but this increase is, in any event, likely to be slight. From these considerations it follows that the 8 per cent sales tax will tend to raise the price to the consumer, in the situation postulated above, not by 14 cents but only by about 9 cents, so that the 8 per cent tax on the manufacturer's price tends to result in an increase of price to the consumer not of 8 per cent, let alone 12 or 16 per cent, but of approximately 5 per cent.[21]

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[20]The popular view implies that of the extra 14 cents which, under the conditions assumed, the consumer has to pay because of the tax the wholesaler gets 2 cents and the retailer 4 cents. Since the government gets only 8 cents, it follows, from the above assumption, that the tax contravenes Adam Smith's celebrated fourth canon of taxation that "every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings in to the public treasury of the state." This conclusion, however, as shown below, is not justified.

[21]In the absence of a sales tax the wholesaler buys an article from the manufacturer for $1 and sells it to the retailer for $1.25, who resells it to the consumer for $1.75. But the tax requires the wholesaler to employ 8 cents more capital in the purchase of the article on which competition will permit him to earn a return of, say, 5 per cent, or .4 cents. Suppose this sum raised by an allowance for enhanced overhead to ½ cent. The tax, therefore, raises the price the retailer must pay to $1.33½ ($1.25+8c (tax)+½c). On 8½ cents of this sum, representing the additional capital outlay necessitated by the tax, the competitive retailer's return will be only 5 per cent (plus a slight allowance for increased overhead per unit sold), or again, approximate-

But even this conclusion rests upon the assumption that the tax is shifted forward by producers and dealers in its entirety to the consumer. To the extent that such complete shifting does not ensue, the increase in price to the consumer, in the illustrative case, will be less than 5 per cent. The fact that the sales tax is a general one, not one confined to a very small number of commodities, facilitates shifting, for sellers of taxed products are virtually free from pressure to absorb part of the tax in order to meet the competition of sellers of untaxed articles. But the readiness with which the tax can be transmitted to the consumer varies both with the nature of the product and the stage of the business cycle. If the product is one for which the demand is relatively inelastic the shifting can be accomplished with ease. But where demand is elastic, sellers face the disadvantage that sales will tend to drop appreciably as price is raised. Under such circumstances part of the tax may be concealed in a variation in quantity or quality, or an attempt may be made to shift the tax backward to the producer of raw materials or to the wage earner, or the sellers may themselves for a time absorb part of the tax. Ultimately, however, the readjustments induced by competition will tend to place the tax burden squarely on the consumer. Generally speaking, the period of adjustment to an increase in the tax will be shorter during the upward phase of the business cycle, when industry is active, than it will be during a recession, when prices are falling and business is declining. The more depressed the industry, the greater the difficulty it will experience in shifting any new tax burden on to the final consumer of its products.

The 8 per cent rate has now been maintained unchanged since May 1936, a period, on the whole, or rising business activity, and there can be few if any instances where the full measure of the tax has still not been passed along to the consumer. But the sharp advances in the tax from 1 per cent in 1930 to 4 per cent in 1931, and then to 6 per

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ly ½ cent. Accordingly, the price to the consumer now becomes \$1.84 $\left(\frac{140}{100} \text{ of } \$1.25 + 9\text{c}\right)$, or 5.1 per cent higher than the old tax-free price of \$1.75.

This tendency for the price increase to the consumer to be kept down to 5% will of course be held in check where elements of monopoly or imperfect competition are present among middlemen.

cent in 1932, were effected at times when prices were falling, when business was contracting, and when the gloom of depression was deepening. Under these conditions, so unfavourable to the smooth and rapid transmission of the added taxes through the channels of industry to the consumer, it is probable that for some time many manufacturers and dealers, in their efforts to check the contraction of orders, absorbed a substantial part of the tax increase.

Since the depression was most deep-seated in the industries producing capital goods, it is reasonable to assume that these are the industries which experienced the greatest difficulty in shifting forward the increases in the sales tax. Whether they absorbed the tax in part or in whole or passed it on, it seems not unlikely that a high sales tax imposed during a depression period on these industries tended to retard their recovery. Consequently, an amendment in July 1938, exempting from sales tax the major products, including structural steel, used in the construction of buildings, was a constructive, though belated, recovery measure.

Manufacturers, it may be added, have to pay sales tax on their purchases of fixed plant, while they have also been obliged to pay the tax, since March 1933, on purchases of non-permanent equipment. Even if they produce their own factory expense materials, for example, castings, tools, dies, etc. they are still required to account for the tax on these goods on the basis of the fair market value just as if they had bought the goods in the open market.[22] How far the sales tax on the price of fixed plant and equipment tended to slow up plant replacement and thereby to retard recovery in the capital goods industries it is impossible to say, but that it exerted some influence in this direction is highly probable.[23]

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[22]Without this provision the manufacturer making his own factory expense materials would be given an advantage, apart from his saving in costs, over his competitor who buys such materials.

[23]No figures are available as to the amount of sales tax paid on purchases of fixed plant. Licensees, as mentioned on page 8, are required to inform the Department merely of the total amount of taxable sales, and of the amount of tax due. If they were asked to give more detailed statements there would probably be much protesting and complaining.

As a possible deterrent factor to plant replacement the sales tax may be compared with the non-recognition for Dominion income tax purposes of obsolescence losses, which in the judgment of many leading

Conclusion

The rising tide of war expenditure and the heavy financial obligations which will inevitably devolve upon the government at the close of the conflict make remote any possibility that the Canadian federal sales tax might be reduced or abolished. On the other hand, although the base of the tax has already been broadened by bringing within its scope new items formerly exempt, hitherto at least, it has not been proposed in any responsible quarter to exploit the revenue possibilities of the tax still further by again raising the rate. That the tax is an elastic one and capable of producing a large revenue experience has amply demonstrated. Moreover, the tax has proved cheap to collect and easy to administer, while taxpayers have become habituated to it and pay it with little or no complaint. Indeed, owing to the method of collection, the greater part of the general public, even if dimly aware that there is such a tax, remains in all probability ignorant of its actual rate. But against these considerations must be set the fact that consumption taxes, among which the sales tax is by far the most productive, were the source, on the eve of the present war, of nearly 60 per cent of aggregate government revenues in Canada. Notwithstanding the exemption of many necessities from sales tax, the burden of the consumption taxes as a whole was markedly regressive. The structure of the income tax, moreover, was such as to permit this regressive burden to extend beyond the classes not subject to income tax into the large moderate income group. In the higher income brackets, however, sharply rising income tax rates redressed the regressivity inherent in the heavy consumption taxes so effectively as to make the total tax load for the well-to-do steeply progressive. Newly imposed war taxes have tended to make the tax system as a whole progressive from appreciably lower income levels, and therefore more equitable. Increased commodity taxation there has been, but almost entirely in the form of enhanced luxury taxes. Direct taxes

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Canadian industrialists, contributed to slow up the renovation of plant.

On the question of obsolescence relief see Report of the National Employment Commission, 1938. Appendix A, pp. 8-9, and "The Burden of Osolescence" by W. H. Wynne, in *The Canadian Chartered Accountant* for April 1937.

In 1939, it may be noted, certain income tax concessions were enacted as a means of encouraging the renovation or extension of plant.

have, however, been greatly extended; the middle income group in particular, which previously escaped lightly, is now subject to much heavier income taxation. While, therefore, the Dominion sales tax is likely to remain for an indefinite period an important element in the Canadian tax structure, the rapid development, under the exigencies of war, of direct taxation, is tending to give Canada a better balanced and more equitable tax system.

ACCOUNTANTS AND THE LAW OF NEGLIGENCE

By W. Summerfield and F. B. Reynolds
London, England

Editor's Note—This series of articles on a subject of wide interest to accountants, written by W. Summerfield, M.A., B.C.L., LL.B., and F. B. Reynolds, A.C.I.B.—authorities in the fields of law and insurance respectively—and appearing in *The Accountant* (London), is published with the kind permission of the Editor of that magazine.

(continued from November 1940 issue)

Damages

It has been observed (see "Negligence") that losses in respect of which compensation is claimed must be shown to be the consequence of the accountant's negligence, for to prove negligence without loss is as inadequate as to prove loss without negligence.

If a plaintiff succeeds in making out his allegation of negligence against an accountant in the discharge of his professional duties, and thereby becomes entitled to compensation, how are the damages to be assessed? This most important question (amongst others) was discussed in the Manitoba Courts in *International Laboratories, Ltd.* v. *Dewar and Others (Peat, Marwick, Mitchell & Co.) (The Accountant*, 28th October 1933, pp. 689-703). The problems which arose for consideration and the legal principles according to which they were determined in that Canadian case were closely analogous to those which would present themselves in similar circumstances in a case brought before our Courts.

Mr. Justice Donovan, who tried the action in the King's Bench Division, found for the plaintiffs, in the sum of $26,209.30, being the amount of the defalcations which had occurred after 30th September 1927, with costs; further, he dismissed, with costs, the counterclaim of the defendants, in the sum of $3,548.75, being the fees for the special in-

vestigation which they had undertaken to determine the extent of the defalcations, and which, in his view, had been rendered necessary by reason of their own negligence. In the Court of Appeal, however, the defendants were exonerated from the charges of negligence.

Defences—Amongst the seven grounds of defence, it was contended (a) that if the defendants had been negligent their negligence had not been "the natural or proximate cause of the loss" sustained by the plaintiffs; and (b) that the plaintiffs had been guilty of contributory negligence.

One Harris had been appointed by the Board of directors of the plaintiff company as accountant and office manager, and he held that office from 28th January 1927 to 14th September 1930. The special investigation conducted by the defendants after Harris had confessed to having misconducted himself in the administration of the finances of the company brought to light defalcations by him during that period totalling $26,727.30. Prior to the commencement of, and throughout, and for some time after that period the defendants were the auditors; but they had undertaken during the relevant period of some three and a half years, according to their contention, a limited audit which did not impose upon them the duty to discover such fraud as in fact occurred—with which aspect of this complex case we do not here concern ourselves.

Audit as Deterrent

Mr. Justice Donovan held that the defendants could not be held liable for such defalcations, amounting to $518, as had occurred prior to the first of their impugned audits for complete years. The defalcations had been begun in small sums and had gradually mounted; in the year ended 30th September 1929 they were ultimately found to have totalled $8,008.59. In the view of the learned Judge, if the defendants had not conducted their audit "in an ostensibly loose manner" Harris would have become apprehensive that the auditors would be likely to detect his manipulations and so would have ceased his malpractices.

In their supplementary audit, the defendants had analyzed the modes in which each of the items of defalcation had been perpetrated and grouped them into classes, lettered from A to I, in a schedule which was closely examined in the Court of Appeal; there the five Judges arrived at

varying conclusions upon some of those classes, on the issue as to whether the defendants, if negligent in fact, could successfully plead that the loss did not flow from their negligence.

Amongst the observations and conclusions to be drawn from the exhaustive judgments, the following are specially noteworthy.

Petty Cash—Item B represented misappropriation of petty cash, totalling $8,229.25. This could not have happened if the plaintiffs had adopted the imprest system as the defendants had advised them to do some time prior to the commencement of Harris's employment, viz. in 1921, 1923 and 1925 (per Prendergast, C.J.M.). But Dennistoun, J.A. (dissenting in part), observed that the defendants knew that Harris was carrying in this account far larger sums than were necessary, and having on the three occasions referred to above recommended that petty cash should be supplied with $200 from general cash, to be replenished as expended, they took no further action when their recommendation was not acted upon. They saw, he proceeded, thousands of dollars going through the petty cash account year by year; "they realized the danger and should have met it with vigilance, but did not do so."

"Economical" Audit

Trueman, J.A., noted that only a most exhaustive check could have uncovered the defalcations, as was to be deduced from the fact that the evidence relating to the classified analysis of them (A to I) extended to 1,800 pages of "minute details." "A complete audit or very extensive checks would have protected the plaintiff. Nothing less would. The footing of additions, in itself a well-nigh interminable task, would have disclosed that peculations and manipulations were taking place, and a vast number of cross-checkings of entries would have had the like result. But nothing less than the tracking down of sales and receipts would show the entire extent of the thefts brought about by the suppression of invoices and cash payments and the juggling done through cheques." An unwise sense of economy seems to have prompted the plaintiffs to conclude an arrangement with the defendants, whereby the cost of the audit, which in 1923 had been $550, was reduced, in 1924, to $350, by narrowing the scope of the audit, having regard

(as they said) to "the efficiency of the internal check." Under the revised arrangement the defendants undertook to make only one visit—at the end of the year—in lieu of monthly visits, and *(inter alia)* "comprehensive tests of the main phases of the year's transactions." If the plaintiffs had succeeded in this case there would have been furnished another striking illustration of the feature we have previously noted in accountancy practice, namely, that there is no direct relation between "size of risk and size of fee." The efficiency of the internal check may be gauged from the conclusion drawn by the Court of Appeal that "the want of an imprest system was taken advantage of by Harris to funnel into the petty cash account all cash, including customers' cheques, and in this way to keep large sums under his hand."

Remoteness — Robson, J.A., emphasized the "remoteness" of damage sustained. No act or omission of the defendants was the proximate cause of the thefts by the servant of the plaintiffs. No omission of the defendants to detect, say in 1927, could properly be said to be the proximate cause of the loss due to Harris' thefts in 1928 or in any subsequent year. But even if it were to be assumed, he added, that the defendants were under a duty to effect detection in 1927, 1928 or 1929, their liability could extend only to such sums as the plaintiffs had been prevented from recovering from Harris (or his guarantors) through failure on the part of the defendants to make the discovery to them in sufficiently good time to enable the plaintiffs to report and prove their losses to the guarantors (in this case bonding companies).

Limited Liability—Dennistoun, J.A., put the matter thus. The defendants could be held liable for thefts of petty cash which they had failed to discover, but they could not be held liable by reason of that failure for thefts committed through other channels, e.g. by suppression of invoices or by reason of the fact that Harris had succeeded in obtaining the necessary signatures to cheques drawn upon the company in favour of himself under an alias (purporting to be the name of a creditor of the company). In brief, auditors are liable "for the losses which fall within the four corners of their contract and are not liable for the others." In this case the defendants' contract had been limited with-

in the four corners of the revised arrangement (with reduced fee).

Assessable Loss — The conclusion is in conformity with the principle enunciated in *Hadley* v. *Baxendale* ([1854] 9 Ex. 341), namely, that in awarding damages to a plaintiff who has been injured by the defendant's breach of contract, the Court aims to place the plaintiff in as favourable a position, so far as monetary compensation can achieve that end, as he would have enjoyed had the contract been properly performed by the defendant. But in computing and assessing the extent of the injury account is to be taken only of such losses as were actually in the contemplation of the parties when they made their contract, or which should have been within their contemplation as reasonable men. Losses outside the scope of such contemplation are deemed to be "too remote."

It cannot be too often or too strongly emphasized that an auditor is not an insurer. Nor does he undertake to detect fraud as the primary object sought to be served by undertaking an audit. To contend that (a) if he had discovered at an earlier stage that an employee of the client was fraudulent and (b) if he had reported the fact to the client and (c) that thereupon the client would have rid himself of that employee and (d) so have avoided the frauds committed at later stages and that, therefore, it is right that the auditor should reimburse the client the whole of his losses may be to resort to too long a chain of causation of damage. The chain of legal liability for losses must necessarily be limited in length. The reasonableness of such a limitation may be demonstrated by this (hypothetical) illustration. A. requested B. to repair his motor-car, and B. undertook to execute the repairs for the following day—at an agreed, moderate, fee. A. called for the car the following day—but it was not ready for him. In consequence A. was unable to keep an appointment out of town. At that appointment A. had hoped to be able to conclude a deal, from which he had hoped to reap, in the course of time, a profit of £5,000. If A. sues B. for failure to fulfil his contract to repair the car, he cannot claim £5,000 as "special damages," for such losses would be too "remote."

No hard-and-fast rule, however, can be laid down whereby the length of the chain of liability for losses suffered by the client can be assessed in general terms. The chain

will be longer or shorter according to the particular facts of each case including, more especially, the terms of the auditor's retainer. An example of the type of case where a somewhat lengthy chain has been fastened upon the auditor is to be found in *Armitage* v. *Brewer and Knott* [1932]

THE INCOME WAR TAX ACT OF CANADA

Departmental Rulings

The following rulings respecting the administration of the *Income War Tax Act* have been issued recently by the Department of National Revenue, Income Tax Division:

Accelerated Depreciation

Enquiries are frequently received as to the allowance of additional depreciation on machinery where the use of such asset in the earning of income has been greatly increased over the normal use.

The amount of depreciation allowable where the assets are in use during the normal working day is obtained by applying the various rates authorized by this Division to the admitted cost of the assets. Where the normal time in use is doubled, the amount of depreciation allowable may be increased by one half, and where the normal time in use is tripled, the amount may be doubled.

If the normal time in use is not at least doubled, no additional amount of depreciation will be allowed. If more than doubled, but not tripled, only one half of the normal charge will be allowed as additional depreciation.

"Normal working day" means the usual daily operating period or "shift" excluding all periods of reduced or accelerated operations.

Accelerated depreciation will be allowed on machinery only.

An affidavit in duplicate of an authorized officer, partner or proprietor giving particulars of the extent of increase in time worked must be attached to the Income Tax Return. Such affidavit must show:

(1) The length of the normal working day or "shift."

(2) Number of days that machinery was operated extra time during fiscal period under consideration, specifying
- (a) number of days operated two full shifts,
- (b) number of days operated three full shifts.

(3) Cost of machinery worked overtime as referred to in item (2),
- (a) operated two full shifts,
- (b) operated three full shifts.
- (c) If the same machinery included items (a) and (b) show cost thereof.

It is emphasized that the additional depreciation will only be allowed on machinery owned by the taxpayer and which is actually being worked overtime as described above. For instance, the fact that certain equipment installed by the Government or owned by the taxpayer is being worked extra shifts does not necessarily mean that all the machinery and equipment owned is likewise being worked extra shifts.

The allowance of additional depreciation in accordance with this

memorandum will not require the adjustment of standard profits for Excess Profits Tax purposes.

Additional depreciation will only be allowed if actually set up on the books of the taxpayer and reflected in financial statements as required in the case of ordinary depreciation.

This memorandum is not applicable in respect of assets on which special depreciation is being allowed under certificate issued by the War Contracts Depreciation Board. *(Issued January 1941).*

Depreciation

1. Effective in respect of all assessments which have not as yet been levied, the following assets may be excepted from the 80 per cent rule (which provided that where the asset value has been depreciated to 20 per cent of cost thereafter depreciation will be on the 20 per cent remaining cost and not on the 100 per cent cost)—namely

(a) assets which from the date of acquirement have a useful life of five years or less;

(b) depreciable assets which are relatively limited in aggregate cost (say $25,000 and under);

(c) assets in respect of which rental income arises, where each property rented is depreciated separately according to the year of purchase;

(d) separately distinguishable assets, or each class of asset (classified according to rate of depreciation applicable thereto) which are depreciated separately according to the year of purchase;

(e) assets owned by farmers.

2. In addition to the above, assets may also be excepted from the application of the 80 per cent ruling if a taxpayer so desires, and adopts the following procedure:

(f) that in respect of additions of the 1940 and subsequent fiscal periods, the taxpayer shall consistently adopt the practice of depreciating individual assets separately or of separating the assets into classes (according to the rate of depreciation applying thereto) and of depreciating each class of asset separately according to the year of purchase, and

(g) that in respect of all assets owned as at the end of the 1939 fiscal period, the taxpayer shall separate such assets and relative depreciation reserve into classes (according to the rate of depreciation applying thereto), in which case depreciation will be allowed on the accumulated cost of each class of asset until the depreciation reserve applicable thereto equals such accumulated cost.

3. Where the procedure as outlined in item No. 2 of this memorandum is adopted, but the 80 per cent ruling has been applied to assets prior to the 1940 fiscal period, the taxpayer will have the option of

(h) continuing to claim depreciation on the 20 per cent residual cost of assets of the 1939 and prior periods until such assets are fully depreciated; or

(i) claiming depreciation in 1940 and future income tax returns on the full cost of each class of asset (classified according to the rate of depreciation applying thereto) purchased in 1939 and prior periods until each class of asset is full depreciated. *(Issued February 1941).*

Taxation of Salaries

Please note that for 1939 and subsequent years all employees will be taxable on any salaries or wages, received, without deduction therefrom by way of expenses. (Approved charitable donations and approved superannuation limited contributions are deductions from net taxable income.)

Where commissions are received in addition to salary, or commissions only are received, expenses incurred to earn such income will be allowed up to but not exceeding the amount of commissions received, provided the expenses are properly vouched and are allowable expenses within the meaning of the Act.

A contract requiring the recipient of a fixed salary to use his own motor car, street car, or any form of transportation, in the discharge of his duties, will not alter the fact that a fixed salary is received which must be taxed without deduction of such expenses.

Where there actually exists, as between the employer and the employee, a binding contract entered into prior to the fiscal year concerned, or the commencement of the services to be rendered, and such contract is properly evidenced, whereby the employee receives a travelling allowance, as distinct from salary, then to the extent that the allowance is expended in travelling for and on behalf of the business of the employer, it is not income to the employee, but to the extent not so used and not returned to the employer, such retained funds constitute taxable income of the employee. *(Issued February 1941).*

Automobile Expenses of Commission Agents to Earn Their Income

1. A commission agent operating an automobile (a) exclusively in his business; (b) substantially for business purposes but also for personal purposes, must have his principal or employer certify in writing that the car is essential for the successful conduct of the commission business, if the Inspector of Income Tax so requests.

2. In case 1 (a) expenses (including depreciation) will be allowed 100 per cent if conclusive evidence through properly maintained and continuous records is produced in proof of the expense.

Income tax allowances are not given without proof of the claim. Therefore failure to keep records technically might place the agent in a position whereby he cannot prove his claim although actually it is recognized that it exists. He has placed himself under this handicap and must receive no advantage from it but must suffer detriment occasioned for want of proof. Therefore the Inspector, having regard to the character of the commission agent's business, the amount of gross income declared and the field covered, meaning extensive or small, in the light of these considerations will in no case give higher than 4½ cents per mile on what he estimates to be the minimum mileage that the business might have required. This is to cover all expenses, including depreciation.

3. In the case of 1 (b) because of the personal element, 75 per cent of the expenses (including depreciation) will be disallowed as pertaining to the personal use of the car unless an affidavit is supplied by the commission agent, with evidence of fact contained in the

affidavit, that the car was used to a greater extent than 25 per cent for business purposes.

The Inspector, if satisfied with the affidavit, will allow what the affidavit states to be the percentage of business use but in no case will he allow more than 75 per cent of the expenses (including depreciation) as business expenses. That is, he will definitely cut out 25 per cent of the operating cost simply because the car had a personal use.

In the absence of records (as referred to in paragraph 2 above) the Inspector will give 4½ cents a mile on the 25 per cent or higher mileage as indicated above.

Expenses will include depreciation on actual cost of cars up to but not exceeding $1,800. Depreciation will not be granted in respect of that proportion of cost in excess of $1,800 unless it can be shown that by reason of carrying samples and bulky materials a special type of car approximating a truck is required.

4. The rate of depreciation to be allowed is 20 per cent per annum.

5. Expenses include annual licences, oil, gasoline, grease, insurance premiums, tires, garage rent, and reasonable repairs, but not the cost of accidents or repairs in connection therewith.

6. Losses or gains made on sales, trade-in or other disposal of employee's automobiles will not be taken into consideration for income tax purposes.

7. Where a taxpayer is the recipient of salary and commission, the allowance under this memorandum is in relation to and is limited by the amount of commission received.

Memo *re* "Taxation of salaries" should be read in conjunction herewith.

This memorandum is effective in respect of 1940 and subsequent years. *(Issued February 1941).*

Note: Copies of the above rulings have been posted by the Secretary-Treasurer of The Dominion Association of Chartered Accountants to the members of the Association resident in Canada. In addition copies of two other rulings have been sent, namely (a) "Returns by Members of the Medical Profession," and (b) "Depletion Allowance in Respect of Dividends etc. from Precious and Base Metal and Oil and Gas Producing Companies." Because of their length, rulings (a) and (b) are not published here; any reader wishing to receive a copy of both should send twenty-five cents in silver to the Secretary-Treasurer, The Dominion Association of Chartered Accountants, 10 Adelaide Street East, Toronto. (Money must accompany order).

ECONOMIC NOTES

The Rowell-Sirois Report

Editor's Note: **This is another, and unfortunately the last, in a series of notes on economic subjects by the late Professor McQueen of The University of Manitoba. It was prepared for THE CANADIAN CHARTERED ACCOUNTANT a few days before Professor McQueen met death in the aeroplane crash on 6th February.**

IT has been said by some that the implementing of the recommendations of this Report would mean that we had made constitutional certain procedures by which poor or profligate provinces could raid at will the accumulated wealth or current income of richer or less profligate provinces in the federation. As thus stated, the objection seems plausible. But to state the matter thus involves a misunderstanding of the reasoning lying behind the recommendations of the report.

Let us look for a moment at the charge that profligate provinces will, if the report is implemented, be able to conduct raids upon the wealth or income of the less profligate provinces. We speak only of degrees of profligacy, for the Commission was not able to classify the provinces into profligate and unprofligate. Over a now somewhat prolonged life each of the provinces has had opportunity to sin and some have made more of their opportunities than others, but not enough more that their brethren may safely point the finger of shame. Our past sins are hidden in our public debts and the frequency and magnitude of our errors were so much alike that the Commission wisely recommends similar treatment for us all for our past and a promise of similar treatment to all for the future. They assume the past debts and remove occasions for provincial profligacy in the future.

Granting then that profligacy has been so evenly distributed that no charge that the profligate will raid the unprofligate could be sustained, let us turn to the argument that the poor provinces will, if the report is implemented, raid the wealth and income of the rich provinces. It must be remembered at the outset of any such argument that areas or provinces as such are not raided and do not raid. Raider and raided, if such there be, are Canadian citizens and not places on the map of Canada. That one spot in Canada is inhabited wholly by raiders and some other spot

wholly by raided persons is most unlikely and contrary to all experience. Why, then, it may be asked, has the Commission recommended national adjustment grants in the case of some provinces while it has not done so in the case of others? If Manitoba has been given an adjustment grant and Ontario has not, there is no warrant for assuming that every citizen of Manitoba is benefitting from a raid on every citizens of Ontario. If it did mean that, it would be a most unwarranted and heartless proceeding, for a great part of the Ontario citizenry are themselves already the victims of the inequitable system of taxation which prevails in Canada at the present time. As will be outlined in greater detail elsewhere, those citizens of Ontario in the lower income groups—and they are the great part of the population in any jurisdiction—are now being subjected to a degree of regressive taxation which is common to all their income group in all parts of Canada. The difficulty is that the Canadian tax structure considered as a whole—namely, the federal, provincial and municipal tax load on the typical citizen wherever he dwells—bears unduly on the low income earner. The remedy for this inequitable situation is more progression in the whole tax structure and this the Commission embodies in its recommendations.

Until 1917 the Dominion government withheld its undoubted right to levy a progressive income tax and since that time it has relented in the further imposition of this tax and remained completely out of the succession duty field largely out of concern for the fiscal requirements of the provinces. Some of the provinces have been forced to increase very greatly these taxes while others have imposed them at more moderate rates or completely refrained from their use. The result has been that in certain provinces (often wrongly called wealthy provinces) there have been unutilized reserves of potential progressive taxation while in other provinces there have not. But it must not for a moment be concluded that because there were some unutilized reserves of potential progressive taxation in a given province, the lower income groups in that province were not heavily taxed and heavily taxed in a regressive manner by the working of the tax structure as a whole.

It may be, then, that a province may contain a significant aggregation of wealthy people who are not taxed as heavily as they should be because the instrument of

progressive taxation has not been utilized to the degree it could have been in that area. It has not been so utilized as the Dominion had restricted its use of progressive taxes in order that it should not embarrass a few provinces who relied on these taxes and which had utilized them to the full. Where, however, progressive taxation has not been utilized to the full in certain provinces, we may still find the large part of the lower income groups heavily taxed. This so-called rich province is rich in that it has millionaires who are not taxed to the degree they would be in other provinces; but it is as poor as the rest of the provinces in that the great majority of its citizens are regressively taxed. It is time that we stopped talking about rich and poor provinces and began to talk of rich and poor Canadian citizens in every province and to adjust our whole tax structure accordingly. The present distribution of taxing powers bears heavily on the lower income groups everywhere in Canada and has left islands of unutilized progressive taxation in some areas; but there is no warrant for designating certain provinces as rich provinces and others as poor provinces.

The provinces hesitated for long after Confederation to enter into the direct progressive taxation field and the Dominion only came into the field, and only then with an apology for its boldness, in 1917. The result of the divided jurisdiction is that a powerful fiscal weapon has been but feebly wielded. The war we are engaged in will require the full use of the weapon and the hesitancy in its use by the federal government must of necessity disappear. The Commission suggests that the provinces give up their progressive taxes in return for something. If the bargain is not made, the productivity of provincial progressive taxes must decline, for the Dominion must have the revenues and Hitler will not wait.

The National Adjustment Grants mechanism is the suggested device whereby among other things more progressiveness can be injected into the whole Canadian tax structure and whereby some regressiveness may be removed. This correction in our now distorted tax structure will apply in Ontario as in Saskatchewan and the ordinary Saskatchewan citizen will in no sense be raiding the ordinary Ontario citizen.

If there is any raid involved in the recommendations of the report, it is a raid by the regressively taxed in all parts of Canada on the resources of some who are not as progressively taxed as they should be in all parts of Canada. The additional revenues necessary for implementing the report, it is suggested, and we agree, should come from a broadening of the income tax basis and from a heavier imposition of succession duties by the Dominion.

The Commission has stressed the fact that when considered as a whole the Canadian taxation falls too heavily upon consumption and upon the costs of doing business, instead of falling upon the profitable results of business. If the report is implemented, there is provision for the correction of this situation. If the report is not implemented, there will be no correction of the situation and in addition the Dominion will have to enter the provincial taxation field to a degree that must gravely embarrass all provincial treasuries.

Winnipeg, R. McQueen.
February, 1941.

TABLE OF EXCHANGE RATES

(Kindly supplied by The Canadian Bank of Commerce, Toronto)

	31st January 1941	*15th February 1941*
U.S. Dollars	10-11% P.	10-11% P.
Sterling	443-447	443-447
Australian Pounds	358½	358½
New Zealand Pounds	360	360
South African Pounds	446	446
British West Indian—Dollars	9270	9270
Hongkong—Dollars	2660	2676
India—Rupees	3376	3376
Straits Settlements—Dollars	5251	5251
Finland—Finmarks	199	199
Sweden—Kronor	2637	2637
Switzerland—Francs	2569	2568

There are no quotations for Italy (lire) or for the following countries under the control of Germany: Belgium (belgas), Denmark (kroner), France (francs), Holland (florins), and Norway (kroner).

Note: The above quotations are expressed as follows: Pound currencies—Canadian cents per unit; Continental currencies and sundry British Empire—Canadian cents per 100 units.

THE DOMINION ASSOCIATION OF CHARTERED ACCOUNTANTS

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Council 1940-41

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D. F. Archibald, C.A., Charlottetown T. H. Johnson, C.A., Halifax	The Institute of Chartered Accountants of Prince Edward Island
Wm. H. Campbell, C.A., Montreal H. G. Norman, C.A., Montreal Alfred Smibert, C.A., Montreal	The Society of Chartered Accountants of the Province of Quebec
C. P. DeRoche, C.A., Saskatoon M. Hesford, C.A., Swift Current G. G. Patrick, C.A., Saskatoon	The Institute of Chartered Accountants of Saskatchewan

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Chairman, Committee on Education and Examinations—Gerald Jephcott, F.C.A.
Chairman, Committee on Accounting Terminology—John Parton, F.C.A.
Chairman, Committee on Accounting Research—D. McK. McClelland, F.C.A.

GENERAL NOTES

Our Contributors This Month

WILBUR FRANCIS CHOWN, a graduate in arts of Queen's University (B.A.) and a member of the Institute of Chartered Accountants of Ontario, is connected with the Economics Division (Marketing Service) of the Department of Agriculture at Ottawa. For a number of years Mr. Chown has owned a farm in Ontario. As a practical farmer, a chartered accountant and as one who in his work sees agriculture in its many aspects throughout the Dominion, he is in a position to discuss the sale of agricultural products—the subject of his article this month.

JOHN DOUGLAS CAMPBELL, who writes on "The Source and Application of Funds Statement" is also a graduate of Queen's University (B. Com.) and a member of the Institute of Chartered Acountants of Ontario. Mr. Campbell has already been a contributor to THE CANADIAN CHARTERED ACCOUNTANT. (April and June issues of 1940).

WILLIAM H. WYNNE has already been a contributor to THE CANADIAN CHARTERED ACCOUNTANT, and in the April 1937 issue discussed the subject, "The Burden of Obsolescence." He is a graduate of Cambridge University (Ph.D. 1926), has done considerable work in economic research in Canada, and at present is Professor of Economics at the University of Michigan.

Chartered Accountants and the War

H. G. Norman of Montreal, a member of the Executive Committee of the Dominion Association, has for some time been acting as Financial Adviser to the British Commonwealth Air Training Plan.

The Institute of Chartered Accountants of Saskatchewan announces that the following members are engaged in active military service: H. A. Hunt, R. Patterson and Deputy Assistant Adjutant J. H. Thompson at Dundurn, Saskatchewan; M. W. Kynch at Winnipeg; J. Bruce Lawson, Glyn W. Myers and F. A. Robertson on overseas service; E. E. Stapleford with the R. C. A. F. at Brandon; D. S. Hutcheon with the Royal Canadian Army Pay Corps; and K. S. Gordon with the British Government Purchasing De-

partment, Montreal. The names of A. R. Bevan, J. C. Byers, L. E. Fingarson, J. S. Owen and W. Stempel appeared in the list of those taking the Accountant Officers' Course as published in the October 1940 issue of THE CANADIAN CHARTERED ACCOUNTANT.

The Auditors' Report

From time to time some of the comments and descriptions, which appear in the financial statements of public companies, have been published in this column. The publication of such comments here is not necessarily to be regarded as approval of the form thereof by the Editorial Committee or by The Dominion Association of Chartered Accountants, but rather as information for readers.

Following is the Auditors' Report to the shareholders of *Hinde & Dauch Co. of Canada, Limited* (Dominion charter):

> We have examined the Books and Accounts of Hinde & Dauch Paper Co. of Canada Limited for the year ended 31 December, 1940. As at 30 November, 1940, the Outstanding Accounts Receivable were circularized, requesting confirmation of the accounts in case of any differences. As at 31 July, 1940, members of our staff accompanied employees of the Company during the taking of the Inventories at the principal locations and observed the procedure followed. Subsequently, we checked the count against the Book Records and found that they agreed satisfactorily. We have made test checks of the basis of pricing and of the computations of the Inventories as at the 31 December, 1940.
>
> In conformity with Section 6 (2) (c) of the *Excess Profits Tax Act*, the Directors of the Company have approved the provision of $53,385.26 against future inventory losses.
>
> We certify that all our requirements as Auditors have been complied with and report that, in our opinion, the above Balance Sheet is properly drawn up so as to exhibit a true and correct view of the position of the Company's affairs at 31 December, 1940, and is in accordance with the Books of the Company.

Unemployment Insurance Act

The Department of Labour, Ottawa, has prepared explanatory notes and an index to *The Unemployment Insurance Act, 1940.* These have been bound with the Act, and a copy is obtainable from the King's Printer, Ottawa.

Dominion Prize Winners in the 1940 Examinations of the Provincial Institutes of Chartered Accountants

W. W. Shepherd G. R. Ferguson R. W. Meanwell

Wilmot William Shepherd, Winnipeg, a candidate of the Institute of Chartered Accountants of Manitoba, was awarded the Gold Medal and cash prize of $50 of The Dominion Association of Chartered Accountants for the candidate winning first place in Canada in the Final examination conducted in December 1940 throughout the Dominion by the Provincial Institutes of Chartered Accountants.

Gordon R. Ferguson, Galt, Ontario (formerly of Toronto), a candidate of the Institute of Chartered Accountants of Ontario, obtained the second highest standing in the Dominion in the Final examination and was awarded the Silver Medal and prize of $25 of The Dominion Association of Chartered Accountants. Mr. Ferguson is a graduate of the University of Toronto (B. Com., 1937).

Robert W. Meanwell, Windsor, Ontario, a candidate of the Institute of Chartered Accountants of Ontario, won the Silver Medal and prize of $25 of The Dominion Association of Chartered Accountants for the candidate obtaining the highest standing in Canada in the Intermediate examination of the Provincial Institutes. Mr. Meanwell is a graduate of the University of Western Ontario (B.A., 1937).

Customs and Excise Revenue

According to the Department of National Revenue, Ottawa, the customs and excise revenue for the ten months ending 31st January 1941 was over $127,000,000 in excess of the corresponding period a year ago. Following are the particulars:—

	1939-40	1940-41
Customs duties, net	$ 81,973,711	$103,828,398
Excise taxes, net	130,915,949	216,706,292
Excise duties, net	53,723,378	73,746,372
Sundry collections, net	487,784	509,746
Total	$267,100,822	$394,790,808
Net increase 1940-41 (ten months)	127,689,986	
	$394,790,808	$394,790,808

Income Tax Revenue

The Department of National Revenue announces that there has also been an increase in income tax collections for the ten months ending 31st January 1941 over those of the corresponding period a year ago. These are as follows:

	1939-40	1940-41
Net Collections	$124,510,856	$202,605,597

or a net increase of $78,094,741.

Municipal Finance Officers Association

The 1941 conference of the Municipal Finance Officers Association of the United States and Canada will be held in the Brown Hotel, Louisville, Kentucky, 19th to 22nd May. A sound municipal finance policy for the defence period will be one of the subjects of the conference discussion. Technical problems of accounting, debt, revenue and budget control will feature two days of group meetings.

LEGAL DECISIONS

[Editor's Note: The following are brief summaries of recent decisions of the Canadian Courts as taken, by the kind permission of the Canada Law Book Company, from the *Dominion Law Reports*. In each case reference is made to the volume of the *Reports* where the full judgment may be found. It should be kept in mind that the decisions given may not in every case be final.]

Succession duty—Situs of shares—Transfer office outside Province

(Williams v. *The King)*

Ontario Court of Appeal

A company incorporated under the Ontario *Companies Act* [now R.S.O. 1937, c. 151] has the capacity to maintain a share transfer office in another jurisdiction, and there is nothing in the Act to prohibit a company from establishing such an office outside the Province, so long as it maintains the records required by ss. 101, 102 and 107 to be kept at its Head Office. Therefore, since the situs of shares is the place where they can be effectively dealt with, shares in an Ontario company belonging to a person domiciled in New York where the certificates are found on his death and where the company maintains a branch transfer office, are situate in New York, and hence are not subject to succession duty in Ontario. Moreover, per Masten J.A. (Fisher J.A. concurring), the share certificates were specialties, and thus the shares represented by them were *bona notabilia* situate at the place where the certificates were found.—[1941] 1 D.L.R. 22.

Wills—Gift of company shares vesting on death

(Ganong, Ganong v. *Belyea et al.)*

Supreme Court of Canada

A testatrix bequeathed common and preferred shares in a company to a number of legatees (her intention being that the gifts were to vest on her death) subject to the reservation that such shares should not be transferred to the legatees until payment to the estate of all dividends on the preferred shares (which were 7% cumulative, payable out of profits) accrued to the date of her death and accruing due in the year following her death, "whether earned or declared or not." No profits having been earned, dividends were in arrears for one year at the date of testatrix's death and for the following year.

Held, the legatees were entitled to the immediate delivery of their shares not charged with payment of two years' dividends on the preferred shares. If the qualifying phrase "whether earned or declared or not" were rejected as rendering the reservation itself meaningless, the condition on the transfer of shares could more reasonably be read as not intending the executors to withhold such transfer for more than a year after testatrix's death rather than as being unlimited as to time, but if the latter construction must be adopted, the reservation was void for uncertainty, whether the qualifying phrase was eliminated or not, and the gift alone took effect.—[1941] 1 D.L.R. 433.

PROVINCIAL NEWS

ALBERTA

The Institute of Chartered Accountants of Alberta announces that, subject to the formal approval of the Senate of the University of Alberta, the following are the successful candidates of the Institute in the December 1940 examinations:

Primary: C. W. Hay, J. F. Lacey, I. A. Mackintosh, J. B. Macmahon, J. C. Miller, J. F. Ross, B. C. Tanner, W. K. Tanner, W. L. C. Wallace.

Intermediate: C. H. Douglas, A. V. Johnston, D. B. McClure, K. L. MacFadyen, D. J. Morrison, J. E. Paterson.

Final: A. M. Craig, G. R. McLellan, W. R. H. Nash, R. A. Scott, B. F. L. Symes, F. D. Waines.

The following candidates were successful in Final Law: S. F. Marshall, N. A. Morris.

Supplemental Examinations Granted (Final): T. A. Burwash (Accounting II & III), C. W. Richardson (Auditing).

Subject to the approval of the Council of the Institute, the following are eligible for the prize awards: Primary examination: W. L. C. Wallace, Bronze Medal; Intermediate examination: K. L. MacFadyen, Prize; Final examination: G. R. McLellan, Prize.

BRITISH COLUMBIA

The Institute of Chartered Accountants of British Columbia announces that in the recent uniform examinations

set throughout the Dominion by a joint committee consisting of representatives of each Provincial Institute of Chartered Accountants in Canada, the British Columbia results were as follows:

Final: In the Final Accounting and Auditing examinations first and second places were attained by T. F. Griffin and A. P. Gardner respectively and other successful candidates were James Brown and F. J. R. Shallcross.

Intermediate: In the Intermediate examination the successful candidates were: F. E. Walden and R. J. Casson, first and second respectively, and C. R. Craster, L. E. Cutherbertson, A. B. Duncan, J. W. Hudson, A. H. Jackson, S. S. McLaren, Bernard Moffatt, W. T. Powers, F. J. Vulliamy, M. J. Walton, R. D. Young.

MANITOBA

The Institute of Chartered Accountants of Manitoba announces that the following are the successful candidates of the Institute in the 1940 uniform examinations set throughout the Dominion by a joint Committee consisting of representatives of the Provincial Institutes of Chartered Accountants in Canada.

Intermediate—Edgar M. Baldwin, Peebles Kelly, Kenneth J. Kelsey, Paul Kenway, Patrick Lonergan, Frank C. Moncreiff, Frederick W. Rintoul, Rothero Thacker, Olgier Thorsteinson, Norman G. Wildgoose and Kenneth F. Yuill.

Final—Desmond Campbell, Herbert Hartley, Walter C. MacDonell, Douglas A. McKay, A. Vernon Neil, F. Geoffrey Patrick, Ewen Rankin, J. Murray Reid, Wilmot W. Shepherd, Albert Riley, Wilfred O. Wadge, and Sydney W. White.

Supplemental Examinations Granted—Harold Chudleigh (Auditing) and David Gilman (Accounting I and III).

The Council is pleased to announce that the Dominion Association Gold Medal awarded to the candidate standing first in the Final examination throughout Canada was won by a Manitoba candidate, Wilmot William Shepherd. This candidate was also awarded by the Manitoba Institute the War Memorial Gold Medal endowed by the late T. Harry Webb and the Institute prize of $100.00. A prize of books was awarded to Ewen Rankin, who secured second place amongst the Manitoba candidates.

ONTARIO

The Institute of Chartered Accountants of Ontario announces the following results of the examinations held in December last. G. R. Ferguson, formerly of Toronto now of Galt, won the prize for the second highest standing in Canada in the Accounting and Auditing papers of the Final Examination, and R. W. Meanwell of Windsor won the Silver Medal for the highest standing in Canada in the Accounting and Auditing papers in the Intermediate Examination awarded by the Board of Examiners-in-Chief of the Provincial Institutes. 142 candidates were successful, of whom forty-five wrote the Primary, seventy-one the Intermediate, and twenty-six the Final examinations.

Primary: R. G. Allen, L. F. Anderson, K. S. Arrell, J. G. Arthur, W. S. Axford, G. R. Barrett, Alexander Campbell, B. G. Childs, J. E. Copland, Gordon Couldrey, J. A. Cross, Roy Curtis, E. B. Daubney, R. H. Emerson, V. R. Ensom, J. A. Ferguson, R. E. Ferguson, F. W. Fromm, J. A. Gillies, A. F. Gregory, Robert Greenshields, J. H. Gula, Ben Gurofsky, W. F. Harvie, J. K. Hill, H. L. Howe, D. D. W. Irwin, B. R. James, J. D. Jarvis, F. D. Kemp, J. R. Lussier, Harold Mason, E. G. More, D. T. Myers, L. W. Pastorius, W. N. Richmond, L. G. Sayers, C. A. Sharpe, N. F. Sherwood, J. M. Smirle, Harold Soupcoff, S. S. Spiegel, A. E. Stone, R. W. Thompson, G. R. Yule.

Intermediate: T. C. Adams, R. J. M. Allan, K. W. Ball, F. A. Bennett, A. J. Black, F. Roy Brand, T. R. Caldwell, G. K. Carr, D. S. Chant, J. G. Clements, W. I. Cochrane, D. A. Colquhoun, A. W. P. Coome, J. R. Cunningham, W. J. Davy, N. L. Death, G. B. Donaldson, Hugh Donnan, N. F. Ellison, J. K. Ferguson, Joel Fink, W. J. Gladwell, Harold Gorman, D. R. Gormley, Percy Grimson, J. E. Hall, G. W. Hawes, A. G. Holman, G. A. Holmes, C. G. Horn, A. J. Horning, Cyril Houser, W. D. Howison, P. M. Hutcheson, J. S. Innes, A. G. Isbister, J. B. Kearney, W. E. Kennedy, W. T. D. Lake, J. S. Lang, L. J. MacKenzie, F. A. Matthews, P. C. Metherell, R. W. Meanwell, G. C. Mills, I. G. Milne, H. A. Morris, R. T. McGraw, D. W. McKinnon, H. S. McLellan, S. R. Nicholson, J. M. Page, Edward Peirol, G. S. Pover, W. W. Prest, W. C. Primeau, A. T. Proctor, G. M. Proctor, J. C. Reid, L. F. Rellinger, E. B. Richards, J. F. Roberts, Albert Savlov, H. V. E. Slaney, C. H. Spry, Max

Stern, J. J. Stone, J. C. Tinkham, J. E. Walsh, R. W. Wettlaufer, B. C. Willis.

Final: E. P. Allison, E. H. Ambrose, P. H. Ambrose, R. D. Armstrong, Irving Beckerman, F. H. Buck, E. L. H. Burpee, J. W. Erwin, G. R. Ferguson, A. A. Forbes, D. S. R. Hepburn, G. R. Herington, J. E. Hicks, R. D. Isbister, J. M. Laverdure, B. W. Matthews, J. R. Morrissey, W. J. McDougall, R. S. J. Rooney, G. P. Smith, S. E. V. Smith, N. H. Solmon, L. D. Thomas, H. H. Thomson, B. W. Varty, A. C. Wilson.

Supplemental Examinations: The following passed in all but the subjects indicated in the Final Examination and have been granted supplemental examinations therein: A. M. Adamson (Accounting II & IV), J. D. Anderson (Auditing & Economics), G. E. Armstrong (Accounting III & IV), J. T. Bowles (Accounting III & IV), R. A. Burnes (Accounting II & III & Economics), W. E. Butler (Accounting II & III), F. W. D. Campbell (Accounting II & III), E. A. Carrothers (Accounting II & III), R. J. J. Dallard (Auditing), K. H. Dunn (Accounting I & III), F. W. Fredenburg (Accounting III & IV & Economics), M. Grossman (Accounting II & IV), G. K. L. Hutchings (Accounting III & IV), G. F. Hogarth (Accounting III & IV), C. V. Maltby (Auditing), J. W. Nott (Accounting II & IV), S. L. Orenstein (Accounting II & III), J. A. Ovens (Accounting I & II), R. I. Priddle (Accounting I & III), M. W. Rashkis (Accounting I & III), H. I. Robinson (Accounting III & IV), H. C. Rogers (Accounting II & III), E. B. Smith (Accounting II & III & Economics), H. A. Starr (Accounting II & III), Nathan Stein (Auditing), J. M. Storey (Accounting II & III), M. B. Tennant (Accounting I & II), J. G. Webb (Accounting II & III).

The Institute announces that prize winners amongst candidates of the Institute for standings within the province are as follows:

Primary: First Prize, G. R. Yule, Toronto; Second Prize, R. G. Allen, Toronto.

Intermediate: First Prize, R. W. Meanwell, Windsor; Second Prize, E. B. Richards, Toronto.

Final: Institute Gold Medal, G. R. Ferguson, Galt; George Edwards Prize, W. J. McDougall, Toronto; W. T. Kernahan Prize, F. H. Buck, Toronto; E. R. C. Clarkson Gold Medal, N. H. Solmon, Toronto.

QUEBEC

The Society of Chartered Accountants of the Province of Quebec announces the following results in the December 1940 examinations conducted by the Board of Examiners-in-Chief of the Provincial Institutes of Chartered Accountants:

Intermediate—Passed: Roland Bedard (Quebec City), A. C. Gilmour, Philip Madras, Helen Orbane, J. G. Schwartz, G. R. Wildblood.

Final—Passed full examination: J. L. Hutchison, D. S. Katz, R. N. A. Kidd, E. Lemieux, B.Com., A. H. Mander, P. M. McEntyre, B.Com., J. C. Newland, L. Simkover.

Passed supplemental examination: Ernest Dey (Auditing), M. O. Holt (Auditing), Alan R. Laing, B.Com. (Auditing), R. D. Shepard (Auditing).

Granted supplemental examination: V. Houghton (Auditing), E. S. Leiter, B.Com. (Auditing), L. G. Marrotte, B.Com. (Accounting II and III), Percy Strean (Auditing).

Prizes—Intermediate: Winners of War Memorial Prizes, Philip Madras and J. G. Schwartz, joint winners.

Final: Winners of War Memorial Prizes, P. M. McEntyre, B.Com., first prize; E. Lemieux, B.Com., second prize.

PERSONALS

Messrs. Peat, Marwick, Mitchell & Co. announce that they have assumed Einar M. Gunderson, chartered accountant, as a partner in the firm. Mr. Gunderson, who has been associated with the firm for a number of years, will continue to make his headquarters at the Edmonton office.

W. W. Pollock, chartered accountant, who has for the past five years been connected with the Dominion Income Tax Department, St. Catharines, Ontario, announces that he has established an office for the practice of his profession at 42 James Street, St. Catharines, Ontario.

Ritchie, Brown & Co., 388 St. James Street West, Montreal, announce that they have taken into partnership R. E. Humphrey and J. M. Miller, both members of the Society of Chartered Accountants of the Province of Quebec.

The firm will continue to practise under the present name of Ritchie, Brown & Co., chartered accountants.

OBITUARIES

The Late James Maxtone Graham of Cultoquhey and Redgorton

James Maxtone Graham, C.A., who died on 28th October 1940, was born on the 19th October 1863 at Cultoquhey, of which he, the third son, ultimately became the fifteenth laird, the property having been in the Maxtone family for over 500 years. On completion of his apprenticeship with Joseph Campbell Penney, he was admitted a member of the Society of Accountants in Edinburgh in 1888. Later Mr. Graham entered into partnership with Francis A. Bringloe and on the death of Mr. Bringloe in 1903 assumed as a partner, William Sime, and the title of the firm, Maxtone Graham & Sime remains unchanged at the present time.

In 1911 Mr. Graham came to Canada and opened up business in Montreal. He joined the Society of Chartered Accountants of the Province of Quebec in September 1911, and was associated with the firm of Riddell, Stead, Graham & Hutchison, retaining his connection with that firm after his return to Scotland.

At the time of his death Mr. Graham was one of the auditors of the Royal Bank of Scotland, a director of the Scottish Provident Institution, and chairman of various trust companies. He was treasurer of the Boy Scouts Association and took a keen interest in the progress of that great movement. He was a staunch Freemason, rising to great eminence in Scottish Freemasonry and up to the time of his death acted as Collector of the Annuity and Endowment Fund of the Society of Accountants in Edinburgh, an office which he had held for many years.

Mr. Graham's death is a great loss to the profession and his many friends and associates in Montreal will learn with deep regret of his passing.

The Late John Ingham Sutcliffe

The Institute of Chartered Accountants of Ontario regrets to announce the death at Pickering, Ontario, on 3rd February 1941 of John Ingham Sutcliffe, F.C.A., in his eightieth year.

The late Mr. Sutcliffe had been a member of the Institute since 1905 and served on Council during the years 1911 to 1913. In 1929 he was granted the Fellowship degree.

The Institute extends sincere sympathy to his widow and family, of whom Mr. J. Ingham Sutcliffe and Mrs. Helen Burpee are members of the Institute.

CORRESPONDENCE

Hamilton, 15th February 1941.

The Editor,
The Canadian Chartered Accountant,

Dear Sir:

I think the attention of the members of the Association should be called to a misnomer which appears to be gaining widespread adoption and is even sometimes used by our profession in the annual statements prepared on behalf of our clients. This is the use of the word "Federal" in connection with Dominion income taxes. The legislation imposing this tax is Dominion legislation and the Act is known as the Dominion *Income War Tax Act*. I believe that all references to the taxes imposed under the Act should be made as Dominion taxes and not as Federal taxes. The opinion of other members of the profession on this point might be of interest.

Yours truly,

(signed) M. I. Long,

MIL/EM. Chartered Accountant.

BOOK REVIEW

ACCOUNTING CONTROL BY USE OF STANDARD COSTS

By Gerald H. Gregory

(Fellow of the Australasian Institute of Cost Accountants)

(Published by *The Law Book Company of Australasia Pty Ltd.*, Sydney, 1940, cloth, 200 pp. $6.25 postpaid from The Carswell Company, Toronto)

In many ways this book proved a somewhat difficult one to review—at least from the point of view of the reviewer. It was not easy to decide whether it is a text book or a book of reference. At the outset the author assumes the reader to have a fairly complete knowledge of the principles of Standard Costing and with little or no introduction goes on to deal at great length with technical methods, details and forms. At a later stage it seems to occur to the author that perhaps the reader is not nearly so wise as he has assumed him to be and at that stage the theory receives some attention.

The subject matter of the book is a combination of rather heavy abstract theory and flashes of practical brilliance. Chapter 5 in particular should be of interest to students, who should learn much from a conscientious study of it—not necessarily from its actual contents but from the thought and further research which such reading should provoke.

Here and there throughout the book the author expresses opinions which, at least to the reviewer, are somewhat dogmatic. For example, he attaches particular importance to the book figure for profit or loss on material purchased which arises out of the difference (or variance) between purchases at actual prices and consumption at standard figures. In ordinary circumstances it would seem that this difference would only be a measure of the skill of the estimator who set the standard. If the efficiency of the purchasing department as such is to be gauged at all, then surely the figure to be examined should be the difference between the actual cost and the market price at the time the material is put into production—always bearing in mind that the nature of a particular business should be taken into consideration. In some cases raw material must be ordered well in advance of the time when it will be actually required and where this occurs the manufacturer must take the risk of price increases or decreases which might occur in the meantime (unless his raw material is a commodity in which intelligent "hedging" operations can be conducted). One might, for example, charge purchases of raw material into one account at actual cost, take out quantities consumed into another account at current market prices, and relieve the latter account at standard prices. In this way, differences in the first account would show the skill of the purchasing department, while any deficit or excess on the second account would reveal the skill as an estimator of the person who sets the standard. The process would be a cumbersome one and the results probably not worth the effort involved. However, this example is quoted merely as one of a number of similar contentious points which appear from time to time.

Some of the author's wording may seem strange to the Canadian reader. To take a case in point, in discussing the cost of maintenance of a warehouse he says: "For instance, it could not be regarded as incorrect to capitalize expenditure by inflating stock values to cover (a) wages of staff handling indents on the factory, (b) the cost of handling, etc." After devoting some little thought to this statement one is

forced to the conclusion that what Mr. Gregory means in Canadian terminology is that it can be regarded as correct to increase inventory values by including therein some portion of the cost of warehousing, handling, etc., and that the term "capitalize expenditure" as used by the author really means to increase the value of an asset in the balance sheet. Normally—at least in Canada—the term "capitalize" is used to indicate an increase in value of fixed assets only, as distinct from current assets like inventories.

It should be mentioned that the book is published in Australia and is described as the first book on the subject ever to be published there. It abounds with numerous examples, forms, and rulings and the figures contained therein are expressed in sterling. Most of the examples are drawn up on the "account" method; that is to say, they are shown in the form of ledger accounts with debit and credit sides, as distinct from the "statement" method more universally used here. Nevertheless, from the point of view of the student, the method of submitting examples in "account" form has much to recommend it. Chapter 6 is extremely interesting; a study of it will give the reader an excellent idea as to how basic (or standard) rates are arrived at in practice.

In conclusion, one is bound to admit that a conscientious study of the book should be profitable to the average reader, partially because, as already mentioned, in parts he will probably disagree violently with the author—a tendency which will, or should, cause him subconsciously to marshal his arguments against those put forward by Mr. Gregory; and partially because the book contains much that is enlightening upon a subject which is still enveloped in an aura of mystery.

C. N. Knowles.

Montreal,
12th February,
1 9 4 1.

STUDENTS' DEPARTMENT

R. G. H. SMAILS, C.A., Editor

NOTES AND COMMENT

The Students' Department on behalf of all of its readers extends sincere congratulations to those who were successful in the recent uniform examinations of the Provincial Institutes and to those who surmounted the "final" hurdle it offers every good wish for happiness and success in their chosen career—a career in which the opportunities and hence the responsibilities are greater than ever before.

* * *

The long awaited report of the Securities and Exchange Commission of United States on its investigation into the audit of McKesson and Robbins, Inc. was published in December last and is, from many points of view an astonishing document.[1] It contains five hundred pages of text and four pages of photogravure reproductions of cheques and statement forms, in addition to numerous printed copies of other forms and documents.

For the mass of readers the main interest of the report lies in its disclosure for the first time of the precise nature and scope of the impersonations, collusion, forgeries, and accounting manipulations by means of which Donald F. Coster, alias Philip M. Musica, presented in the published statements of his company approximately $21,000,000 of fictitious assets, $18,247,020.60 of fictitious sales and $1,801,390.60 of fictitious profit. It can safely be said that this class of reader will henceforth regard as pale and insipid fare the efforts of imagination of our professional crime-club writers. The editorial which appeared in the New York Times shortly after the first public disclosure of the McKesson and Robbins case did not, after all, exaggerate when it stated: "Philip Musica achieved what in the field of pure art would have to be called a magnificent act of creation. The observer marvels and gives up as he contemplates the mystery of this extraordinarily gifted man."

[1]*United States of America before the Securities and Exchange Commission in the Matter of McKesson and Robbins Inc. Report on Investigation.* (United States Government Printing Office, Washington, 1940) 60 cents.

The more specialized type of reader who approaches the report as an inquest into the nature and adequacy of the audit procedures finds himself confronted by an enquiry of a type which would have been unthinkable as recently as a dozen years ago and which might induce many a young man who was not already committed to public accountancy as a profession to veer off into medicine or architecture as being less hazardous pursuits. The situation is that there has been constituted in the Securities and Exchange Commission an administrative tribunal differing substantially in its membership and outlook from the ordinary court of law, and that this tribunal has conducted an examination more technical and therefore more searching than that to which any auditor has previously been exposed.

We would hesitate to express any opinion on the findings of the Commission as stated in Section V of the report and summarized in Section I until we had had an opportunity of discussing them and arguing about them with those who bear the brunt of practice. Meanwhile however we can safely say that we are impressed by the substance of Section III E which is somewhat misleadingly entitled "Control Exercised by Directors over the Foreign Crude Drug Business," by the difficulty experienced and time taken by Julian F. Thompson, while the treasurer and a director of the company, in confirming his belated suspicion that "something was wrong," and by the fact that the United States corporation laws permitted the president of a company to restrict the scope of the audit of his corporation as Coster restricted the scope of the audit of McKesson and Robbins, Inc.

* * *

PROBLEMS AND SOLUTIONS

Solutions presented in this section are prepared by practising members of the several provincial Institutes and represent the personal views and opinions of those members. They are designed not as models for submission to the examiner but rather as such discussion and explanation of the problem as will make its study of benefit to the student. Discussion of solutions presented is cordially invited.

PROBLEM I.

THE PROVINCIAL INSTITUTES OF CHARTERED ACCOUNTANTS

ACCOUNTING I

Question 3. (20 marks)

A company which manufactured domestic electrical appliances incorporated in 1936 a subsidiary company which was to retail the

goods on an easy payment plan. The risks pertaining to this type of business being fully realized, it was decided that the subsidiary would take into profits only that proportion of the gross profit which the actual cash collected in any year bore to the original sales. For this purpose each year was to be considered as a unit and the unrealized gross profit from year to year was to be carried in a deferred income account. During the first four years of operations the sales and cost of goods sold were:—

Year	*Sales*	*Cost*
1936	$300,000	$225,000
1937	550,000	385,000
1938	700,000	476,000
1939	600,000	420,000

Cash collections were as follows:—

	From sales made in			
	1936	*1937*	*1938*	*1939*
1936	$ 50,000	....	....	....
1937	100,000	$100,000	....	....
1938	100,000	300,000	$200,000	....
1939	25,000	120,000	250,000	$150,000

(1) Submit journal entries recording the gross profit taken into earnings at the end of each of the four years.
(2) Prove the balance in the deferred income account at the end of 1939.

SUGGESTED SOLUTION

Summary of transactions:

Items	*1936*	*1937*	*1938*	*1939*
Sales	$300,000	$550,000	$700,000	$600,000
Cost	225,000	385,000	476,000	420,000
Gross profit	75,000	165,000	224,000	180,000
Percent of gross profit to sales	25	30	32	30

(1) Journal entries:

			Dr.	Cr.
1936	Deferred profit		$ 12,500	
	To Profit and loss			$ 12,500
	To transfer proportion of profit earned for the year			
	25% of $ 50,000 =	$ 12,500		
1937	Deferred profit		55,000	
	To Profit and loss			55,000
	25% of $100,000 =	$ 25,000		
	30% of $100,000 =	30,000		
		$ 55,000		
1938	Deferred profit		179,000	
	To Profit and loss			179,000
	25% of $100,000 =	$ 25,000		
	30% of 300,000 =	90,000		
	32% of 200,000 =	64,000		
		$179,000		

1939	Deferred profit	167,250	
	To profit and loss		167,250
	25% of $ 25,000 = $ 6,250		
	30% of 120,000 = 36,000		
	32% of 250,000 = 80,000		
	30% of 150,000 = 45,000		
	$167,250		

(2) Balance in the deferred income account at the end of 1939 would be:

Total gross profits made up—

1936...............	$ 75,000	
1937...............	165,000	
1938...............	224,000	
1939...............	180,000	$644,000
Less: Amounts drawn down—		
1936...............	12,500	
1937...............	55,000	
1938...............	179,000	
1939...............	167,250	413,750
		$230,250

This should provide for gross profit on accounts net yet collected, calculated thus:

Year	*Sales*	*Amount Collected*	*Balance Owing*	*Profit %*	*Profit Deferred*
1936	$300,000	$275,000	$ 25,000	25	$ 6,250
1937	550,000	520,000	30,000	30	9,000
1938	700,000	450,000	250,000	32	80,000
1939	600,000	150,000	450,000	30	135,000
					$230,250

PROBLEM II.

THE PROVINCIAL INSTITUTES OF CHARTERED ACCOUNTANTS

INTERMEDIATE EXAMINATION, 1940

ACCOUNTING I

Question 4. (30 marks)

From the following trial balance of Jonesboro Steel Co. Limited, as at 31st December 1939 prepare—

(a) Work sheet for preparation of manufacturing statement, profit and loss statement and balance sheet.

(b) Adjusting and closing journal entries.

Accounts	*Debit*	*Credit*
Factory expense—fixed	$ 50,000	
Factory expense—variable	100,000	
Selling expense	75,000	
General expense	35,000	
Land, building and machinery	500,000	
Cash	60,000	
Raw materials inventory, 31st December 1938	15,000	
Work in process inventory, 31st December 1938	10,000	
Finished goods inventory, 31st December 1938	50,000	
Accounts payable		$ 40,000
Marketable investments	75,000	
Loss on sale of investments	2,500	
Reserve for depreciation		125,000
Surplus		250,000
Accounts receivable	80,000	
Purchases of raw materials	275,000	
Purchases of finished goods	35,000	
Goodwill	500,000	
Sales		700,000
Direct labour	252,500	
Capital stock—preferred		250,000
Capital stock—common		750,000
	$2,115,000	$2,115,000

Supplementary data:

(1) Inventories on 31st December 1939 are—

Raw materials	$125,000
Work in process	35,000
Finished goods	150,000

(2) Depreciation of $25,000 is to be provided.

(3) Accrued payroll is to be allowed for as follows—

Direct labour	$ 4,000
Factory superintendence	1,500
Salesmen's salaries	2,500
Office salaries	1,000
	$ 9,000

(4) Prepaid expenses are—

Taxes	$ 1,600
Insurance	1,400
Advertising	1,000
	$ 4,000

(5) A dividend amounting to $43,500 was declared on 15th December payable 15th January.

(6) A reserve for bad debts equal to 1% of sales is to be set up.

(7) The factory was closed down during the entire month of July 1939 due to lack of orders.

(8) The accounts receivable ledger contains credit balances totalling $15,000 for prepayments by customers.

(9) The accounts payable ledger contains debit balances totalling $6,000 for goods returned to suppliers.

SOLUTION

JONESBORO STEEL CO. LIMITED

(a)

Work Sheet — 31st December 1939

Accounts	Trial Balance Dr.	Trial Balance Cr.	Adjustments Dr.	Adjustments Cr.	Manufacturing Dr.	Manufacturing Cr.	Profit and Loss Dr.	Profit and Loss Cr.	Surplus Dr.	Surplus Cr.	Balance Sheet Assets	Balance Sheet Liabilities
Factory expense—fixed	$ 50,000	......	$25,000(2)(4) 1,500(3)(7)	$3,000 6,125	$ 67,375	......	......	......	......	......	......	......
Factory expense—variable	100,000	......	......	......	100,000	......	......	......	......	......	......	......
Selling expense	75,000	......	2,500(3)(4)	1,000	......	......	$76,500	......	......	......	......	......
General expense	35,000	......	1,000(3) 7,000(6)	......	......	......	43,000	......	......	......	......	......
Land, building and machinery	500,000	......	......	......	......	......	......	......	......	......	$500,000	......
Cash	60,000	......	......	......	......	......	......	......	......	......	60,000	......
Raw material inventory	15,000	......	......	......	15,000*	$125,000	......	......	......	......	125,000	......
Work in process inventory	10,000	......	......	......	10,000*	35,000	......	......	......	......	35,000	......
Finished goods inventory	50,000	......	......	......	......	......	50,000	$150,000	......	......	150,000	......
Accounts payable	......	$40,000	......	......	......	......	......	......	......	......	6,000	$ 46,000
Marketable investments	75,000	......	......	......	......	......	......	......	......	......	75,000	......
Loss on sale of investments	2,500	......	......	......	......	......	2,500	......	......	......	......	......
Reserve for depreciation	......	125,000	......	25,000(2)	......	......	......	......	......	......	......	150,000
Surplus	......	250,000	......	......	......	......	......	......	......	$250,000	......	......
Accounts receivable	80,000	......	......	......	......	......	......	......	......	......	95,000	15,000
Purchases of raw materials	275,000	......	......	......	275,000*	......	......	......	......	......	......	......
Purchases of finished goods	35,000	......	......	......	......	......	35,000	......	......	......	......	......
Goodwill	500,000	......	......	......	......	......	......	......	......	......	500,000	......
Sales	......	700,000	......	......	......	......	......	700,000	......	......	......	......
Direct labour	252,500	......	4,000(3)	......	256,500	......	......	......	......	......	......	......
Capital stock—preferred	......	250,000	......	......	......	......	......	......	......	......	......	250,000
Capital stock—common	......	750,000	......	......	......	......	......	......	......	......	......	750,000
Shut down cost	......	......	6,125(7)	......	......	......	6,125	......	......	......	......	......
Accrued payroll	......	......	......(3)	9,000	......	......	......	......	......	......	......	9,000
Prepaid expenses	......	......	4,000(4)	......	......	......	......	......	......	......	4,000	......
Dividend payable	......	......	......(5)	......	......	......	......	......	43,500	......	......	43,500
Reserve for bad debts	......	......	......(6)	7,000	......	......	......	......	......	......	......	7,000
Cost of goods manufactured	......	......	......	......	......	563,875	563,875	......	......	......	......	......
Net profit	......	......	......	......	......	......	73,000	......	......	73,000	......	......
Surplus balance	......	......	......	......	......	......	......	......	279,500	......	......	279,500
	$2,115,000	$2,115,000	$51,125	$51,125	$723,875	$723,875	$850,000	$850,000	$323,000	$323,000	$1,550,000	$1,550,000

(b)

Journal entries—

Factory expense—fixed	$ 25,000	
To Reserve for depreciation		$ 25,000
To increase reserve as instructed		
Direct labour	4,000	
Factory expense—fixed	1,500	
Selling expense	2,500	
General expense	1,000	
To Accrued payroll		9,000
To provide for proportion of salaries and wages earned to date		
Prepaid expenses	4,000	
To Factory expense—fixed		3,000
Selling expense		1,000
To set up prepaid taxes, insurance and advertising		
Surplus	43,500	
To Dividend payable		43,500
To provide for dividends declared by directors on 15th December, payable 15th January		
General expenses	7,000	
To Reserve for bad debts		7,000
To establish reserve equal to 1% of sales		
Shut down cost	6,125	
To Factory expense—fixed		6,125
Transferring 1/12 of fixed expense to separate account—		

Ledger balance	$50,000
Accrued payroll	1,500
Depreciation	25,000
	$76,500
Prepaid expenses	3,000
	$73,500
1/12 =	$ 6,125

Manufacturing (or work in process) account	723,875	
To Factory expense—fixed		67,375
Factory expense—variable		100,000
Raw materials inventory		15,000
Work in process inventory		10,000
Purchases of raw materials		275,000
Direct labour		256,500
Transferring costs to manufacturing account		
Raw materials inventory	125,000	
Work in process inventory	35,000	
To Manufacturing account		160,000
To set up inventories		

Profit and loss account	563,875	
To Manufacturing account		563,875
Transferring balance in latter account, being cost of goods manufactured during the year		
Profit and loss account	213,125	
To Selling expense		76,500
General expense		43,000
Finished goods inventory		50,000
Loss on sale of investments		2,500
Purchases of finished goods		35,000
Shut down cost		6,125
To transfer costs and expenses		
Sales	700,000	
To Profit and loss account		700,000
To close sales account		
Finished goods inventory	150,000	
To Profit and loss account		150,000
To set up closing inventory		
Profit and loss account	73,000	
To surplus		73,000
To transfer net profit to surplus account		